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United Nations Conference
on Trade and Development

Distr.
GENERAL

TD/B/C.3/232
6 February 1990

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Committee on Invisibles and
Financing related to Trade
Thirteenth session (first part)
Geneva, 5 February 1990
Agenda item 2

AGENDA 1/

1. Election of officers

2. Adoption of the agenda and organization of work

3. Review of international monetary and financial questions related to trade and development, including, in particular, official development co-operation 2/

4. Debt and managing adjustment: attracting non-debt-creating financial flows and new lending 2/

5. Invisibles: insurance

6. Review of the work programme of the Committee

7. Other business

8. Provisional agenda for the fourteenth session of the Committee

9. Adoption of the report of the Committee to the Trade and Development Board.

1/ Adopted by the Committee on Invisibles and Financing related to Trade at its 215th meeting on 5 February 1990.

2/ To be considered at the second part of the Committee's session.

GE.90-50253

UNITED
NATIONS

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United Nations Conference
on Trade and Development

Distr.
GENERAL

TD/B/C.3/233
8 February 1990

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Committee on Invisibles and Financing
related to Trade
Thirteenth session (first part)
Geneva, 5 February 1990

REPORT OF THE BUREAU ON CREDENTIALS

In accordance with rule 17 of the rules of procedure of the main Committees of the Trade and Development Board, the credentials of all the representatives attending the first part of the thirteenth session of the Committee were examined in a meeting of the Bureau which recommended that they be accepted.

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on Trade and Development

Distr.
GENERAL

TD/B/C.3/234
19 February 1990

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Committee on Invisibles and Financing related to Trade
Thirteenth session (second part)
Geneva, 30 April 1990
Agenda item 4

DEBT AND MANAGING ADJUSTMENT: ATTRACTING NON-DEBT-CREATING FINANCIAL FLOWS AND NEW LENDING

Report by the UNCTAD secretariat

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INTRODUCTION, SUMMARY AND CONCLUSIONS

1. The rhythm of development in many developing countries has come to be dominated by the interaction between the overhang of external debt and the economic policies pursued domestically. This report examines some of the principal issues falling under these two headings. The first chapter examines recent trends in the treatment of bilateral official and officially guaranteed debt, and of debt to commercial banks. The second discusses the budgetary experience of developing countries and the issues involved in fiscal adjustment. Each chapter addresses the linkages between the external and internal dimensions of resource mobilization, and draws conclusions regarding international and national policies.

2. In the recent past, the policy stance of official bilateral creditors has improved significantly, especially with regard to debt owed by the poorest sub-Saharan African countries. A number of positive changes have been introduced in the terms of Paris Club reschedulings, including multi-year agreements and longer maturities for a small number of countries and, most important, the Toronto initiative to provide concessional debt relief. This progress, however, has not yet been translated into a substantial alleviation of the debt burden of rescheduling countries. The implementation of the Toronto measures has pointed to several shortcomings. The eligibility criteria are very restrictive, and exclude even a number of countries that are IDA-eligible; the scale of relief is extremely limited; and the consolidation period is too short. Moreover, the additionality of these measures has not always been ensured.

3. There is need for bolder action, to ensure that the scale of relief on official debt is commensurate with the debt-servicing capacity of debtor countries. The impact of the Toronto agreement should be expanded significantly by broadening the eligibility criteria, enhancing its concessionality, widening the coverage of consolidated debt, applying multi-year rescheduling and urging other bilateral creditors to adopt comparable measures. Consideration should also be given to debt and debt-service reduction for middle-income countries whose debt is mostly owed to official creditors. Some progress has recently been made in reducing the burden of multilateral debt. But further measures - supported by bilateral efforts - are needed to clear arrears and avoid the risk of default for a number of debt-distressed countries.

4. As commercial banks have succeeded in reducing their exposure to troubled debtors, their reluctance to extend new loans to them has increased. However, the amount of voluntary debt and debt-service reduction has been small, largely because of the financial weakness of debtors. The scope for such operations has become more significant following the Brady initiative, as a result of which IMF and World Bank will lend to countries for the purpose of providing collateral for debt and debt-service reduction. The recent strengthening of the debt strategy marks a turning point in that action by multilateral agencies and creditor governments to promote debt and debt-service reduction is now considered appropriate. Nevertheless, the debt relief in prospect still falls far short of what debtors need in order to grow out of their over-indebtedness. The scale of debt reduction by commercial banks could be enhanced by providing them with further incentives through increased support from bilateral sources or a multilateral "debt facility", and/or by systematic resort to suasion of various kinds. Conditionality is another important issue. Eligibility for debt-reduction should be based on a forward-looking approach which recognizes the complexity of the difficulties of achieving stability and growth, and the contribution that debt reduction can make to fiscal adjustment.

5. Many developing countries, especially those with heavy debt burdens, have experienced macro-economic disorder as well as stagnation in recent years. External shocks, and the budgetary costs of import cuts and of certain policy prescriptions such as trade liberalization and currency depreciation were the main factors behind the sharp worsening of fiscal balances that took place in the early part of the 1980s. As a result, in many countries the internal debt of the public sector and the monetary base escalated sharply. Massive efforts were made to reduce budget deficits, and the aggregate deficit is now no higher than in the late 1970s. But the cuts in public expenditure that this process has entailed has damaged growth potential. Moreover, the deficit that remains presents a serious problem because it cannot be covered by foreign borrowing.

6. Both the incompleteness of fiscal adjustment and the intensification of inflation are rooted in the difficulties of reconciling the income claims of different social groups in the face of negative

or negligible output growth and huge outward transfers of resources. To put an end to macroeconomic disorder therefore requires lifting the external debt burden, arriving at a social consensus on how the burdens and fruits of adjustment are to be shared, and stepping up investment, especially in exports. Growth cannot be sustained for long without stability; but since income growth is essential in order to obtain social consensus, a revival of development is best viewed as a prerequisite, and not simply as the end product, of financial stabilization.

Chapter I

DEBT

7. During recent years the pervasiveness of debt problems among developing countries has caused debt rescheduling to become an established feature of the financial system. This statement holds for debts to banks and for official debts in the form of officially insured or guaranteed private export credits and direct lending from bilateral official sources; obligations to multilateral creditors, however, have remained intact.

A. Official debt

1. Recent developments in official debt rescheduling

8. By the end of 1988, the official debt of developing countries - that is money owed to governments and multilateral financial institutions - had grown to $478 billion, accounting for almost half of total long-term external debt, as compared to two fifths at the end of 1982. Debt-service payments on official debt rose rapidly to $52 billion in 1988, or about 40 per cent of total debt service. Bilateral creditors account for somewhat more than half of official debt stock. Since the onset of the debt crisis, a large proportion of bilateral debt service has been either in arrears or repeatedly rescheduled within the Paris Club. In the late 1980s, an increasing number of countries were forced to accumulate arrears with multilateral institutions and consequently barred from further loans from them.

9. Official debt rescheduling within the Paris Club has played an increasingly important role in providing significant short term cash flow relief to debt-distressed countries, especially to sub-Saharan African countries (for which official bilateral debt accounts for more than 40 per cent of total debt) and to lesser extent, to Latin American debtors. Official reschedulings, however, also contributed to the increase in bilateral debt, through the capitalization of interest. Capitalized interest now represents 25 per cent of total non-concessional debt of sub-Saharan debt-distressed countries. In 1988 alone, bilateral creditors capitalized $2 billion in interest arrears.

10. The pace of rescheduling has recently accelerated, with no less than 22 meetings of the Paris Club taking place in 1989, against an average of 17 during 1983-1987 (see table 1). This increased level of rescheduling activity is itself a symptom of the acute debt-servicing problem persistently faced by the majority of the developing countries, as well as of the short-leash approach of the Paris Club. Because of the short consolidation periods (typically between 12 and 18 months), of the 33 countries involved in rescheduling agreements in 1988-89, 26 had rescheduled at least once before. Of these, 14 had already come to the Paris Club three times or more. Moreover, debt service on previously rescheduled debt has become an increasingly important - and sometimes the predominant - portion of the consolidated amount, indicating the inadequacy of the terms of the original rescheduling.

11. In the recent past, a number of improvements were introduced in the terms of Paris Club rescheduling. The most significant development was the Toronto agreement on concessional debt relief for poorer debtors. A detailed assessment of the implementation of the Toronto initiative is provided in section 2 below. Other important changes in Paris Club practices include: the re-introduction - albeit limited - of multi-year rescheduling agreements (MYRAs), and lengthening in the maturities of reschedulings.

Table 1

DEVELOPING-COUNTRY DEBT RESCHEDULINGS WITH OFFICIAL CREDITORS, 1988-1989

Country	Date of meeting	Cut off date	Consolidation period (months)	Percentage of principal and interest consolidated	Grace period	Repayment period	De minimis (SDRs)	Arrears	Rescheduling of previously rescheduled debt	Good-will clause	Amounts rescheduled, estimate in US dollars (mn.)
1988											
Ecuador	01/1988	01/01/1983	14	100	6ys 1m	4ys 6ms	1,000,000	yes	yes	no	438
Gabon	03/1988	01/07/1986	12	100	6ys 0m	4ys 6ms	500,000	no	no	yes	326
Togo	03/1988	01/01/1983	16	100	9ys 2ms	7ys 6ms	1,000,000	no	yes	yes	139
Malawi	04/1988	01/01/1982	14	100	11ys 1ms	9ys 6ms	500,000	yes	yes	no	27
Niger	04/1988	01/07/1983	12	100 75 [a]	11ys 1m	9ys 6ms	250,000	no	no	yes	37
Yugoslavia	06/1988	02/12/1982	15	100	7ys 1m	3ys 6ms	1,000,000	yes	yes	yes	1291
Brazil	07/1988	31/03/1983	20	100 70 [a]	6ys 8ms	4ys 6ms	1,000,000	yes	no	no	4992
Jamaica	10/1988	01/10/1983	18	100	6ys 3ms	4ys 6ms	500,000	yes	yes	yes	147
Madagascar**	10/1988	01/07/1983	21	100	Toronto terms		250,000	yes	yes	yes	254
Mali**	10/1988	01/01/1988	16	100	Toronto terms		250,000	yes	n.a.	yes	63
Morocco*	10/1988	01/05/1983	18	100	6ys 3ms	4ys 6ms	1,000,000	yes	yes	yes	969
Bolivia*	11/1988	31/12/1985	15	100	7ys 1m	3ys 6ms	500,000	yes	yes	yes	307
Central African Republic**	12/1988	01/01/1983	18	100	Toronto terms		250,000	yes	yes	no	28
Niger**	12/1988	01/07/1983	12	100	Toronto terms		250,000	yes	yes	yes	48
Tanzania**	12/1988	30/06/1986	6	100	Toronto terms		500,000	yes	yes	yes	337
1989											
Senegal**	01/1989	01/01/1983	14	100	Toronto terms		500,000	yes	yes	yes	135
Trinidad and Tobago	01/1989	01/09/1988	14	100 [b]	6ys 1m	4ys 6ms	500,000	yes	n.a.	yes	490
Uganda**	01/1989	01/07/1981	18	100	Toronto terms		500,000	yes	yes	yes	101
Nigeria	03/1989	01/10/1985	16	100	6ys 2ms	4ys 6ms	1,000,000	yes	yes	yes	6426
Guinea**	04/1989	01/01/1986	12	100	Toronto terms		500,000	yes	yes	yes	124
Guyana	05/1989	31/12/1988	14	100	11ys 1m	9ys 6ms	500,000	yes	n.a.	no	195
Cameroon	05/1989	31/12/1988	12	100 85 [a]	7ys 0m	3ys 6ms	500,000	yes	n.a.	no	535
Philippines	05/1989	01/04/1984	25*	100 75 [a]	7ys 7ms	3ys 6ms	1,000,000	yes	no	yes	1850
Costa Rica	05/1989	01/07/1982	14	100	6ys 1m	4ys 6ms	1,000,000	yes	yes	yes	182
Mexico	05/1989	31/12/1985	36*	100 [c]	6ys11ms	3ys 6ms	1,000,000	no	no	yes	2400
Mauritania**	06/1989	31/12/1984	12	100	Toronto terms		500,000	yes	yes	no	52
Togo**	06/1989	01/01/1983	15	100	Toronto terms		500,000	yes	yes	yes	76
Benin**	06/1989	31/03/1989	13	100	Toronto terms		500,000	yes	n.a.	yes	193
Zaire**	06/1989	30/06/1983	13	100	Toronto terms		1,000,000	yes	yes	yes	1530
Angola	07/1989	31/12/1986	15	100	7ys 3ms	3ys 6ms	1,000,000	yes	yes	yes	432
Jordan	07/1989	01/01/1989	18	100 50 [a]	6ys 3ms	4ys 6ms	500,000	yes	n.a.	yes	586
Gabon	09/1989	01/07/1986	16	100	5ys 4ms	6ys 0m	500,000	yes	no	no	545
Ecuador	10/1989	01/01/1983	14	100	7ys 1m	3ys 6ms	1,000,000	yes	yes	no	
Guinea-Bissau**	10/1989	31/12/1986	15	100	Toronto terms		250,000	yes	yes	yes	
Mali**	11/1989	01/01/1988	26*	100	Toronto terms		250,000	yes	no	yes	
Côte d'Ivoire	12/1989	01/07/1983	16	100	9ys 2ms	5ys 6ms	500,000	yes	yes	yes	
Argentina	12/1989	10/12/1983	15	100	7ys 1m	3ys 6ms	1,000,000	yes	yes	yes	

Source: Paris Club Agreed Minutes.

Note: The grace period is defined to start at the beginning of the consolidation period. N.a. means not applicable. * Multi-year rescheduling. ** Beneficiary of concessional debt relief measures agreed upon at the Toronto summit.

a First percentage relates to principal, second to interest.

b Percentage relates only to principal.

c Percentage relates only to principal; consolidation of interest is 100 per cent the first year, 90 per cent the second year and 80 per cent the third year.

12. Following a hiatus after the unsatisfactory experience with the three MYRAs concluded during 1985-86,[1] in 1989, there has been a return to MYRAs for the Philippines, Mexico, and Mali in line with their extended arrangements (in the case of Mali a SAF arrangement) with the IMF. This is a welcome development. But wider use of this practice would imply much more extensive recourse to the multi-year IMF facilities than presently appears to be in the offing.

13. The year 1989 also witnessed the application of the so-called "Venice terms",[2] that is longer maturities than the standard 10-year, to debt rescheduled by countries not benefiting from the Toronto terms. Under this new policy, Guyana received a 21-year maturity with an 11-year grace. A 15-year maturity with 9-year grace was agreed for Côte d'Ivoire. This improvement has further differentiated the rescheduling terms by creating an intermediate category between the standard terms and the Toronto terms. Although this change toward a more flexible approach is positive, it should be recalled that, as with option B under the Toronto menu, longer repayment periods entail neither additional cash flow relief in the short- and medium-term, nor concessionality. Thus, the Venice terms should not be seen as a proxy for the Toronto terms as they fail to provide debt or debt-service reduction required by many rescheduling countries which are not yet beneficiaries of the Toronto terms.

14. Despite the recent improvements, the essential features of the established operational framework of the Paris Club remain fundamentally intact.[3] With few exceptions, official creditors continue to require that a rescheduling country has concluded a prior arrangement with the Fund. This means that consideration of the debt problem by the Paris Club is often delayed, thus leading to a further deterioration in the country's financial position. In a few rescheduling agreements negotiated in 1989, the link with Fund conditionality became even stronger, as official creditors made the implementation of the agreement contingent upon the debtor country meeting the performance criteria under the stand-by arrangement with the Fund.

2. The Toronto agreement in practice

15. The Toronto summit in June 1988 marked a major advance in the stance of official creditors with regard to non-concessional debt owed by poorer debtors. In accepting the principle that in specified cases the servicing of such debt might not be met in full, official creditors agreed to the need for debt and debt service reduction. However, the meagre outcome of the Toronto agreement was not commensurate with the amount of political effort that was necessary to strike the deal.

16. The implementation of the Toronto initiative led to the adoption of the following menu of options to be chosen by creditor countries in rescheduling the official bilateral debt of selected low-income countries within the framework of the Paris Club: (A) partial forgiveness of debt service, under which one-third of the consolidated debt service is cancelled and the remaining two-thirds rescheduled at market interest rates, with a maturity of 14 years, including 8 years of grace; (B) longer repayment periods, under which consolidated debt service is rescheduled at market interest rates, with a maturity of 25 years, including 14 years of grace; and (C) concessional interest rates, under which the consolidated debt service is rescheduled at market interest rates reduced by 3.5 percentage points or 50 per cent, whichever is less, and with a maturity of 14 years, including 8 years of grace. For official development assistance (ODA) debt, it was agreed that the maturity would be as in option B, and the interest rate as low as the original rate, regardless of the option chosen.

17. By the end of 1989, 15 sub-Saharan African countries[4] all of them included in the World Bank's Special Programme of Assistance (SPA) and many of them least developed countries,[5] had benefited from the Toronto measures. Option A had been applied to about 35 per cent of con-

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1 For an account of this experience, see "Review of the implementation of the guidelines contained in Board resolution 222(XXI)", report by the UNCTAD secretariat (TD B 1167), para. 33-35.

2 At the Venice summit in 1987, the G-7 agreed to extend longer repayment and grace periods to low-income countries. This was a prelude to the concessional terms adopted at the Toronto summit in 1988.

3 For full discussion of these features, see TD B/1167.

4 Benin, Central African Republic, Chad, Equatorial Guinea, Guinea, Guinea-Bissau, Madagascar, Mali, Mauritania, Niger, Senegal, Togo, Uganda, United Republic of Tanzania and Zaire

5 Countries eligible for the SPA are those sub-Saharan countries which receive only IDA funds, have a debt-service ratio of at least 30 per cent, and are undertaking internationally approved adjustment programmes.

solidated non-concessional debt (by two creditors, including France), option B to 30 per cent (by four creditors, including the United States), and option C to 35 per cent (by ten creditors, including most European countries and Japan).

18. Implementation so far has pointed to several shortcomings of the Toronto measures with regard to eligibility, scale of relief, timing and additionality. While there are no formal *eligibility* criteria, creditors have denied the benefits of the arrangements in recent reschedulings to IDA-eligible, debt-distressed countries such as Nigeria, Guyana and Bolivia which are not SPA countries. The *scale* of relief resulting from the Toronto measures is extremely limited. As compared with previous practices, options A and C - but not option B - will generate cash-flow benefits for beneficiary countries during the grace period in the form of savings on interest payments, which are estimated to be roughly equivalent to 30 per cent of interest payments under previous Paris Club terms. However, these savings are less than 2 per cent of their total debt-service payments in 1989. The debt-service payments that would have to be met by several poorer countries after the application of the Toronto measures would still be three times higher than the cash payments these countries have been able to make in recent years. The extremely small impact of the Toronto measures reflects the low concessionality of the scheme. At a discount rate of 7 per cent (that used in the OECD Consensus definition of concessionality for mixed export credits), options A and C introduce grant elements of 33 per cent and 27 per cent respectively, while option B carries no concessionality. For the 15 beneficiary countries, the overall grant element was, on average, 21 per cent, less than half of the average grant element of current official loan commitments to low-income African countries. Another factor responsible for the limited scale of the measures is that previously rescheduled debt, arrears and late interest are not fully consolidated in some cases, while short-term debt and servicing of debt contracted after the cut-off date[6] are excluded from the rescheduling. The *timing* of the rescheduling process has not been much improved by the Toronto measures. Ideally, these measures should be applied to the entire stock of debt outstanding, in order to bring about once-and-for-all debt or debt-service reduction. Until very recently, when Mali obtained a multi-year rescheduling agreement, only debt-service payments falling due during a relatively short consolidation period benefited from the Toronto terms, so that recourse was still necessary to time-consuming and costly repeated reschedulings. Finally, the *additionality* resulting from the Toronto measures has been reduced by the decisions of some creditors to finance the cost of debt relief by the transfer of funds from their aid budgets to their ECAs.

19. Other steps to relieve the debt burden of low-income countries have recently been taken by creditors. Following the adoption of Board resolution 165(S-IX) in 1978, a number of poorer countries, especially least developed countries (LDCs), benefited from measures taken by DAC creditor countries concerning retroactive terms adjustment of concessional debt. By 1988, these measures had resulted in debt relief for an amount estimated at approximately $7 billion, of which $4.8 billion[7] for the LDCs. Over the past two years, several creditor governments announced additional measures to cancel concessional debt of a number of low-income countries. Belgium agreed to forgive about $180 million of bilateral official debt owed by 13 African countries (70 per cent of which is owed by Zaire). The French Government announced its intention to cancel $2.5 billion equivalent of ODA debt owed by 35 IDA-eligible African countries. The Federal Republic of Germany agreed to cancel about $1.4 billion of ODA debt of six low-income sub-Saharan African countries implementing adjustment programmes. The United States decided to write off up to $1.3 billion of ODA loans made to Sub-Saharan African countries implementing adjustment programmes. The USSR indicated its readiness to grant debt write-offs or 100-year moratoria to least developed countries. When all these measures are implemented, the bulk of ODA debt owed by low-income countries would be cancelled. The full implementation of resolution 165(S-IX) is needed. At the same time, it has to be complemented by further concessional relief on non-concessional debt, as ODA debt-service accounts for a relatively small share of scheduled debt service of poorer debt-distressed countries.

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6 The cut-off date is the date before which debt must have been incurred, if it is to be eligible for rescheduling. Creditors are reluctant to accept changes in the cut-off date for subsequent reschedulings since they would entail the inclusion in renegotiations of exports credits granted since the initial rescheduling.

7 Of this amount, $3 billion represented outright debt cancellation, $450 million were in the form of a waiver of interest payments and $1.3 billion were accounted for by the conversion of payment of debt in local currency. See UNCTAD, *The Least Developed Countries, 1988 Report* (United Nations publication, sales No. E.89.II.D.3), particularly table 28, pp. 108 and 111.

3. Conclusions

20. Over the past few years, the policy stance of official bilateral creditors has improved significantly, especially with regard to debt owed by the poorest sub-Saharan African countries. This progress, however, has not yet translated into a substantial alleviation of the debt burden of rescheduling countries. Bolder measures are needed to obtain a meaningful debt relief that would help avoid the ballooning of debt and repeated reschedulings.

21. The debt relief resulting from the Toronto measures has proved to be very limited. This underlines the necessity of:

(a) reviewing the eligibility criteria, so as to increase considerably the number of beneficiary countries. As a first step, all least developed countries and all IDA-eligible countries should benefit from the Toronto treatment;
(b) for countries meeting the revised elegibility criteria:
  (i) enhancing significantly the concessionality of the measures, especially for the most distressed countries. This could be achieved by abandoning option B, raising substantially the grant element of options A and C, and writing off the entire ODA debt;
  (ii) widening the coverage of consolidation up to 100 per cent of Paris Club obligations. For most countries, during the period immediately ahead the increase in debt relief that would result from bringing forward the cut-off date would by far outweigh any possible negative impact on new export credits. Many poorer countries would in fact be able to attract and afford only highly concessional flows for many years to come;
  (iii) applying multi-year rescheduling to all beneficiary countries, with the length of the consolidation period related to their financing needs rather than to the length of IMF arrangements;
  (iv) ensuring additionality through a closer co-ordination between the Paris Club and donor groups; and
  (v) the consideration by other bilateral creditors - such as OPEC countries and East European countries - of the adoption of comparable measures. This might lead to an increase of up to 50 per cent in cash-flow savings.

22. In the case of middle-income countries whose debt is mostly owed to official creditors, the strengthened debt strategy, which has embodied the principle of debt reduction, poses a major challenge to bilateral creditors. It has been widely recognized that traditional rescheduling techniques tend to postpone and, in most cases, exacerbate the debt problem. Timid efforts have recently been made to tackle this issue by extending longer repayment periods to such lower middle-income countries as Côte d'Ivoire and by re-introducing MYRAs. These improvements represent a step in the right direction, but for many debtor countries in this category, debt and debt-service reduction will be required to remove the debt overhang. This will raise a number of difficult problems for official creditors and debtors alike, including (a) the financial consequences of debt reduction operations for ECAs and eventually for the creditor governments' budget; (b) the possible adverse impact on new export credits. Despite these problems, the issue of official bilateral debt reduction deserves urgent consideration.

23. With regard to multilateral debt, some progress has been made recently in lowering the burden of such debt on low-income countries, following the establishment of SAF and ESAF in the Fund, and the World Bank programme of interest relief on outstanding IBRD loans owed by IDA-only countries. ESAF resources will soon need to be replenished. Possible additional ways - including interest subsidy schemes with bilateral support - of alleviating the burden of debt-service obligations to multilateral institutions, while safeguarding the financial viability of these institutions, should be urgently studied and instituted. In addition, an increased number of effective support groups of donor countries should be established to help poorer countries clear arrears to multilateral institutions. As regards multilateral debt owed by middle-income countries, in the near term a return to positive net transfers from multilateral financial institutions (MFI) would avoid the risk of default for a number of highly indebted countries. Over the longer term, the multilateral debt burden might become unbearable if massive involvement by the MFI in these countries in the context of the Brady plan is not accompanied by much larger reductions in other types of debt.[8]

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[8] A detailed analysis of this issue is contained in the report "The external financing of development" (TD B C.3 235) paras. 72-74.

B. Debts to commercial banks

24. Over time, commercial banks have succeeded in reducing their vulnerability vis-à-vis troubled developing country debtors. However, those countries have failed to revive growth and attain external payments viability. Consequently, the prospects for reviving new bank lending to them are poor. The needed reduction of negative net transfers must therefore be achieved primarily by substantially reducing debts and debt service to commercial banks, and by expanding new official lending. However, only half the reduction needed is in prospect.

1. Trends in lending

25. Since 1988, commercial bank claims on developing countries have been declining in absolute terms as banks have reduced new lending and adopted a strategy of reducing their exposure to troubled debtors. The trend has been especially marked as regards the highly indebted countries. Between 1987 and the recent adoption of a "strengthened debt strategy" (see section 3 below), only four agreements included new concerted lending.

26. It is doubtful whether the increasing difficulties of assembling new money packages experienced during the "Baker Plan" can be reversed. In the early years of the debt crisis, high exposure rates gave the major creditor banks a common interest in supplying new money in order to avert default. They were, moreover, in a position to oblige smaller creditors to participate *pro rata*. Over time, however, all banks have succeeded in reducing their *pro rata* exposure ratios and in building reserves against eventual loan losses, albeit to differing degrees. They have also become more averse to developing-country risk. Consequently, although banks would undoubtedly prefer simply to receive full servicing most now see reduction of their level of exposure as offering a more certain outcome than trying to improve the quality of their exposure by adding to it. This is clearly the case for those banks which have managed to lower significantly their exposure rates and to set aside sizeable loan-loss provisions, and which are therefore able to absorb the book-keeping losses from selling (or converting) loans at a discount. But other creditors whose high exposure rates and/or low rates of provisioning militate against debt reduction are also extremely reluctant to keep adding to their exposure. Such banks can be expected to participate in concerted lending only for big debtors, and only when, and to the extent that, the alternative is discontinuation of debt servicing.

27. Regulatory pressures also run counter to increased lending. In order to comply with the Basle Agreement, many banks will need to raise their capital ratios, which they can do by limiting the expansion of their assets and by raising more capital.[9] Moreover, the high rate of provisioning now prevalent has greatly raised the cost of new lending to developing countries, much of which has to carry reserves at the higher rates. United States banks that previously maintained reserve ratios on their developing country loans of about 5 per cent now carry provisions of 30 per cent or more (in one case 100 per cent), and the current norm appears to be 40-50 per cent; the main clearing banks in the United Kingdom have ratios of at least 50 per cent.

28. For banks with high developing country exposure, equity issues will be particularly difficult, since equity markets have been penalizing the share prices of banks with high exposure. This increases not only the costs of raising capital, but also the risks of hostile take-over bids - a consideration of great concern to bank managers. Depositors, too, are wary of highly-exposed banks.

29. Moreover, most banks are eager to meet the new opportunities for growth and profit opening up in the newly-liberalized financial markets of developed countries. Seizing such opportunities is of greater concern to them than improving the quality of their claims on developing countries.

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[9] For a discussion of the Basle Agreement, see *Trade and Development Report, 1989*, Annex 2. Under the Basle Agreement, general loan loss reserves will become part of Tier 2 or supplemental capital (while in the United States, for instance, such reserves were formerly treated as part of primary capital). Such reserves will be taken into account only up to a limit of 1.25 per cent of total risk based assets. Any reserves exceeding this limit will remain as idle resources, and will thus be costly.

2. Reduction of exposure

30. Many banks have responded to the pressures on them to supply resources by searching for alternatives to new money. The "market-based menu" in recent agreements has offered a variety of instruments and devices such as onlending and relending facilities, debt-equity conversion mechanisms, exchange offers with collateralization, debt buy-backs, and exit bonds.[10] The menu approach is attractive to banks because it provides the flexibility needed to take account of differences in their financial positions and objectives, prudential regulations, accounting and tax treatment, etc. About $30 billion of developing country debt is estimated to have been retired through debt reduction practices in the past two years, the two main mechanisms being debt buy-backs and debt-equity swaps.[11]

31. United States banks have recently been active in reducing their exposure both in absolute terms and relative to their capital. This trend has been marked not only for the smaller but also the larger creditors. Improved financial positions and increased loan-loss provisions have significantly increased the ability of banks to sell loans at a discount (and to resist pressure for new lending). The claims of banks from other major creditor countries have also declined overall.

32. Nevertheless, the overall amount of debt reduction has been small relative to the stock of debt. On the one hand, the scale of debt-equity swaps has been circumscribed by a variety of factors, including their potentially disruptive macroeconomic consequences, such as an over-expansion of the supply of money and credit, and the danger of "round-tripping". On the other hand, the scope for buy-backs and debt conversions has been limited by the shortage of foreign exchange. The secondary-market price of developing country debt has, meanwhile, dropped steeply, to register an average level of 33 cents on the dollar in mid-1989.

3. The "strengthened debt strategy"

33. In the face of the impasse resulting from the reluctance of banks to lend and the inability of debtor countries to continue to finance resource outflows on the scale recently experienced, official thinking on the debt problem has undergone a turning point. It is now recognized that the debt problem involves questions of insolvency as well as illiquidity, and that excessive debt burdens discourage adjustment. Moreover, whereas in the past official involvement in debt reduction was shunned, it is now accepted that, given the limited capacity of debtors to provide collateral, the scale of debt-reduction needs to be enlarged by official action, including financial support from official sources.

34. The "strengthened debt strategy" that has been put in place following the "Brady initiative" centres around the new policy guidelines adopted by the IMF and the World Bank which enable the official institutions for the first time to finance - albeit indirectly, by means of lending to debtor countries - various methods of private debt reduction or debt-service reduction: (a) around 25 per cent of a country's drawings from the IMF under standby or extended arrangements can be set aside to support reduction of principal, as can around 25 per cent of its World Bank structural adjustment loans over a three-year period (10 per cent of total lending where lending is primarily for projects);[12] and (b) in addition, up to 40 per cent of a country's Fund quota, and up to 15 per cent of its overall three-year lending programme from the Bank, can be used for interest support.[13] The Bretton Woods institutions, together with Japan, will in theory be able to extend around $30-35 billion for debt and debt-service reduction.

35. However, the restrictiveness of the guidelines makes it unlikely that actual use will approach this limit. For one thing, countries not in a position to accept Fund and Bank conditionality are

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[10] For an explanation of the terms "on-lending" and "relending" facilities, "exchange offers with collateralization", "exit bonds" and "round tripping" see *Trade and Development Report, 1989*, Part One, chap. II.B.

[11] Morgan Guaranty Trust Co., *World Financial Markets*, December 1988 and World Bank, *World Debt Tables 1989-90*, Vol. I, Analysis and Summary Tables, p. 17.

[12] Amounts set aside would be used for operations involving reduction of debt principal, such as buy-backs or exchanges.

[13] Additional lending could, for instance, be used to fund a special escrow account to guarantee interest payments on new bonds carrying either a lower face value (deep discount bonds) or a reduced interest rate (par-value, reduced-interest bonds), or a combination of the two, issued by the borrower in exchange for bank debt.

not eligible to receive any of the resources. For another, access to resources under the interest-support guideline, which account for well over half the total pool, requires special justification, reflecting the strength of the country's medium-term programme. If, as a result, such support were restricted to countries which have succeeded in fulfilling policy conditions for several years, debtor countries unable to achieve macroeconomic equilibrium without a reduction of the net outflow would not benefit. Suitable domestic policies are essential; but in order to break the vicious circle of domestic disorder and external resource shortage (see chapter II), it is important to ensure that countries are not denied debt relief because of poor performance in the past when good performance is unattainable in the future without such relief.

36. The guidelines adopted by the Fund and Bank imply that these institutions will support debt and debt-service reduction only at substantial discounts. If the main creditors agree among themselves to offer debt sales or exchanges only at modest discounts, countervailing power will need to be exercised. The recent decision of the IMF no longer to insist that a member be current on its debts to banks before drawing on its resources could help. But other steps may also be required, on the basis of a firm assessment of the debtor country's resource needs.

37. But even if the $30 billion were fully used and significant discounts obtained, debt burdens appear likely to be reduced by only 15-20 per cent.[14] The minimum reduction needed by the "Baker 15" taken together has been estimated at about 30 per cent of all their debt to commercial banks, i.e., 36 per cent of their medium- and long-term debt to such creditors.[15]

38. Since no significant increase in the level of new official lending (other than the Japanese funds mentioned above) has been included in the strengthening of the debt strategy, considerable weight continues to be placed on new bank lending, debt-equity swaps and the return of flight capital (the stock of which is thought to be huge). However, it is questionable whether those sources can make up for the shortfall in debt and debt-service reduction. As already explained, banks are likely to become more, rather than less, reluctant to increase lending as their exposure rate declines; several debtors have suspended debt-equity programmes adopted under creditor pressure because of the inflationary impact; and flight capital is not likely to return on a significant scale until after several years of stability and growth. The strategy thus appears unlikely to have the necessary impact on external payments and receipts and therefore appears unlikely to achieve its goal of overcoming overindebtedness through growth.

39. Three agreements in principle have so far been concluded in the context of the "strengthened debt strategy": by Mexico, the Philippines and Costa Rica, each of which is of strategic importance to one or more of the creditor governments. The three packages differ substantially from one another in a number of respects, including the roles given to new lending and debt reduction.

40. Mexico's agreement in principle with its commercial bank creditors, announced in July 1989, gave the latter three options: (a) to convert existing loans into new 30-year bonds carrying market rates of interest but at 65 per cent of face value ("discount bonds"); (b) to convert such loans into new bonds of equal face value ("par bonds") but carrying a fixed interest rate of 6.25 per cent which is well below current market rates; and (c) to provide new money totalling 25 per cent of their exposure over four years. Whereas new money would carry no guarantees, the principal of both types of new bonds would be fully collateralized, as would the interest on par bonds for a limited period. Banks representing about half of Mexico's public and publicity guaranteed medium- and long-term debt have chosen par bonds, while those representing about 40 per cent have opted for discount bonds. The new money option has been chosen by banks accounting for only 10 per cent of exposure - half the figure originally expected. It would appear that the debt reduction which will occur via option (a) will be matched by new borrowing, leaving the total stock of indebtedness unchanged; that option (b) will yield net annual savings in interest payments of some $700million for many years (i.e. 8 per cent of total debt service); and that the country's cash flow will also benefit from new money amounting to $1.2 billion a year over a four-year period. The agreement appears to have considerably reduced Mexico's flexibility to restructure its debt again in the future. The extent of its need for such flexibility will depend critically on how far the

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[14] This can be illustrated by assuming that one half of the pool is used to reduce the debt to banks of the highly indebted countries through an exchange of debt at a discount of 40 per cent for an alternative financial instrument, whose repayment is guaranteed by a 20-year zero-coupon bond with an interest rate of 8.3 per cent, and that the other half provides a two-year rolling guarantee on the interest payments on the alternative financial instrument. Interest payments would then fall by about $3.7 billion for these countries, i.e., about 15 per cent of their current obligations. The reduction of principal would amount to less than 20 per cent of their medium- and long term debt to banks.

[15] See *Trade and Development Report, 1988*, Part One, chap. IV.

agreement succeeds in its objective of attracting back flight capital. The first indications in this respect have been positive, but it remains to be seen whether capital repatriation will be sustained over time on a significant scale.

41. The Philippines agreement, announced in April 1989, continues to place emphasis on new money. Reflecting the fact that 20 banks hold one half of that country's public and publicly guaranteed medium- and long-term debts to commercial banks and 100 banks a mere 3.5 per cent, the agreement gives creditors two options: (a) to provide new money in the form of loans or bonds with 15 years' maturity and 8 years' grace, and carrying market rates of interest; it had been hoped that $1 billion over two years would be forthcoming in this way; (b) to sell loans to the government at a discount; it was agreed that the Central Bank offer to buy back $1.3 billion at a 50 per cent discount. Thus far, only around $600 million in new money has been committed and the deadline has been extended in an effort to bridge this shortfall. The debt purchase component, on the other hand, has been concluded as targeted; indeed, demand totalled considerably more than the $1.3 billion ceiling. It is expected that the Philippines will also be able to use up to $1.5 billion directly and indirectly derived from official sources for cash buy-backs and credit support for debt exchanges for discount or for bonds, and to use up to $300 million a year from any source for such purposes in certain circumstances. It should be noted that the Philippines' bank debt is about a quarter of its total debt (compared to one half in the case of Mexico), and that official lenders have been willing to considerably enlarge their lending, though not enough to avoid a financing gap.

42. Costa Rica's agreement differs substantially from both Mexico's and the Philippines', reflecting that country's small size and the relative importance of its arrears. No new money is involved, the emphasis being on reducing debt and debt-service obligations and clearing arrears: (a) banks will be invited to tender their loans for cash at a price to be announced by Costa Rica (reportedly a very small fraction of face value); (b) all commercial bank debt not so tendered will be converted into new bonds carrying an interest rate fixed at 6.25 per cent; and (c) Costa Rica will immediately pay 20 per cent of the unpaid interest, amortizing the rest over 15 years, with no grace period, at a commercial interest rate. Banks tendering at least 60 per cent of their exposure will both receive more credit enhancement on the new bonds they obtain, and a guarantee (for three years) on rescheduled interest arrears. Cash for the buy-backs and interest support is to be provided by the IMF and World Bank, and by various bilateral donors. It would appear that the agreement will significantly reduce the amount of debt and debt service owed by Costa Rica. Nevertheless, that country will actually pay out considerably more than in recent years, when it was in arrears.

4. Conclusions

43. The overall amount of commercial debt and debt-service reduction that is in prospect appears too small to set in train a sustained process whereby troubled debtor countries would adjust and grow out of their over-indebtedness. The question thus arises how to strengthen either the incentives offered to or the pressures applied on creditors to reduce debt or debt service.

44. It would be difficult for the IMF and the World Bank, given the technical limits on their lending power, significantly to enlarge their own support while ensuring additionality for the recipient without diverting funds from other developing countries. However, finance from national sources could be expanded without meeting the same technical limits. Such finance could be used either to bolster the present approach, or, alternatively, to provide the base for a new debt facility which would borrow from capital markets a multiple of its paid-in capital and use it to provide sufficient collateral on new bonds to induce creditors to give hefty discounts. Many proposals have been made in this vein, most recently by WIDER.[16]

45. If finance for collateralization proves inelastic it would be necessary to give greater weight to suasion. There would appear to be considerable scope for resort to disincentives of various kinds to ensure that creditors do not avoid debt-reduction. Such disincentives might include a clear international policy of tolerating or even encouraging arrears as a means of persuading reluctant creditors to reduce debt and debt service on the scale deemed desirable on the basis of an objective

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[16] See *Trade and Development Report, 1988*, chap. IV, sect. C.3 and *Trade and Development Report, 1989*, chap. II, sect B.4.

assessment by international financial agencies. They might also include an array of measures at the national level in creditor countries such as requiring that any tax benefits from provisioning be shared with debtors.

46. The issue of conditionality also needs to be addressed. In determining eligibility for significant debt reduction it is important to take a forward-looking approach rather than one which gives preponderant weight to the country's past "track record" of carrying out agreed programmes. Moreover, due account needs to be taken of the policy dilemmas that arise when a country is expected to attain major adjustments simultaneously in different areas. The fiscal and monetary targets set in adjustment programmes should fully reflect the contribution that debt reduction can make towards domestic finance equilibrium and in reconciling otherwise conflicting policy objectives. These issues are discussed at greater length in the following chapter.

Chapter II

FISCAL ADJUSTMENT IN DEVELOPING COUNTRIES

A. Introduction

47. In recent years, many developing economies, notably those with acute payments difficulties, have experienced acute macroeconomic disorder domestically. This disorder has manifested itself in various macroeconomic imbalances, including high rates of inflation, rapid monetary expansion, exceptionally high interest rates, and very large fiscal deficits, as well as low rates of investment and growth.

48. Many observers have attributed the inflation and external deficits to the pursuit of excessively expansionary fiscal policies. While such policies are often the main cause of internal and external disequilibrium, the origins of the disorder experienced by developing countries in recent years lie elsewhere. The emergence of large payments deficits in the early part of this decade sprang from abrupt changes in external variables rather than shifts in domestic policy. These changes gave rise to a huge outward transfer of resources and sharp currency depreciations, which in turn provided a powerful impetus to inflationary pressures. The massive deterioration that occurred in budget balances, and the rapid growth of internal debt and the money supply which followed, were therefore the outcome, not the source of monetary and financial instability and loss of growth momentum.

49. Analysis of the impact of external shocks on the external accounts has not been lacking. However, relatively little attention has as yet been paid to the disruptive impact of those shocks on domestic financial variables. This chapter attempts to fill that void, and demonstrates that the shocks, together with the fact that many of the measures taken to redress external imbalances have themselves widened fiscal deficits, have caused governments in many debtor countries to lose control over the fiscal and monetary aggregates. The social and political constraints have limited the range of policy choice, making it extremely difficult for governments to regain full control.

50. The external shocks of the late 1970s and early 1980s disrupted public sector accounts through two main channels. First, the rise in interest payments swelled public sector deficits while cutbacks in lending created a financing gap. In many countries the external transfer problem became also a domestic transfer problem leading to an intense struggle between the private and public sectors over the size and composition of the budget. Where the private sector's export earnings had to be used to service the public sector's foreign debt, an improved fiscal performance implied taxing success in exports, with possible damage to the process of structural adjustment. Secondly, the collapse of commodity prices reduced government revenues, notably in countries exporting minerals.

51. The policy measures taken to restore external balance and the trade-balance improvements themselves have damaged the government budget in several ways: (a) reduction in imports and tariff levels have lowered revenues from trade taxes; (b) currency depreciations have raised the domestic currency cost of debt servicing and of imports for public investment; and (c) debt conversion has tended to aggravate the domestic transfer problem.

52. The slowdown in economic activity and the acceleration of inflation have also contributed to the widening of public sector deficits. First, real tax revenues from incomes and profits, and transactions in domestic goods and services, have been reduced by recession, collection lags and tax deductibility of corporate interest payments in the context of inflation. Secondly, cuts in public spending have reduced public sector revenues, in the short run through their deflationary effect, and in the long run because investment cuts have reduced the scope for increasing efficiency in public enterprises. Thirdly, domestic nominal and real interest rates have risen to very high levels

at a time when governments have had to replace foreign with domestic borrowing, giving rise to an unprecedented pace of domestic debt accumulation.

53. The fiscal challenge facing many developing country govenments in the 1980s has thus been to counteract strong influences beyond their control. Despite extemely adverse circumstances, many debtor countries have managed to bring pubic sector deficits from the very high levels they reached during the 1980s to the levels of the late 1970s. However, the deficit must now be covered by domestic financing rather than foreign loans. The next section will examine this experience and the following ones will describe the various influences summarized above.

B. Fiscal and monetary experience

1. External shocks and fiscal balances

54. Table 2 gives deficits of the consolidated central government budget (i.e. the traditional concept of "budget deficits"), as well as estimates of deficits for the public sector as a whole for a number of countries for which the data are available. It also shows, for a smaller number of countries, central bank losses which have also been a source of monetary expansion.[17] Public sector deficits - i.e. the public sector borrowing requirement (PSBR) - are typically greater than that of the central government budget because of deficits of state and municipal governments and, particularly, public enterprises. Nevertheless, there is a close correspondence between their movements; central government deficits are directly influenced by the financial position of other parts of the public sector because of transfers from the budget.

55. With few exceptions central budget deficits were moderate during the late 1970s - about 3 per cent of GDP. For the highly indebted countries included in table 2, such deficits were, on average, less than 2 per cent of GDP, and primary deficits (i.e. deficits excluding interest income and payments) almost nil. The sizeable deficits registered by some low-income countries reflected foreign aid flows for development expenditures. The PSBR, on the other hand, was much greater, reaching or exceeding 10 per cent of GDP in a number of countries. While this was partly due to operating losses of public enterprises, it reflected, in large part, an excess of investment over savings financed by borrowing from abroad. In several countries which subsequently experienced debt crisis, the level of the PSBR was sustainable given the value of other variables such as interest rates.

56. After the jump in world interest rates and recession in 1979-1982, however, budget deficits shot up almost everywhere. In the highly indebted countries, they increased more than threefold, reaching, on average, 6 per cent of GDP; interest payments as a proportion of GDP almost doubled, while primary deficits rose to reach 3 per cent of GDP. The PSBR also rose steeply, particularly for some major debtors, largely because of the increased interest payments. An important part of these deficits was initially financed by stepping up external borrowing. However, fiscal adjustment became unavoidable following the cutback in commercial lending after 1982.

57. The fiscal burden of external debt subsequently also rose because many governments assumed the private sectors' external liabilities. In a number of Latin American countries the socialization of private sector liabilities raised the debt burden of the public sector by 15-20 per cent. Moreover, assumption of financial losses of private firms and banks, and exchange rate guarantees and preferential exchange rates given to private debtors led to sizeable central bank losses in a number of countries. (In Chile, for instance, such losses amounted to almost 10 per cent of GDP during 1986-1987; when added to PSBR, they raised public sector deficits in that country to the levels of the high-deficit countries of the region.)

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[17] In these tables, and in a number of other tables and charts in this chapter where changes (swings) in a given period are indicated, the comparison is always of one period (usually a biennium) with another. For example, 1978-1979 (or 1978-79), refers to an average of the two years 1978 and 1979. Where an average of fiscal years is compared with one for calendar years (e.g. budget deficits as a proportion of GDP) the fiscal year is that which overlaps to the greatest extent with the calendar year.

Table 2

BUDGET BALANCES AND CENTRAL BANK LOSSES IN SELECTED DEVELOPING COUNTRIES

(Percentage of GDP)

Country	Consolidated central government budget						Total public sector budget [a]						Central bank losses		
	Total balance			Primary balance [b]			PSBR [c]			Primary balance [b]					
	1978-1979	1981-1982	1986-1987	1978-1979	1981-1982	1986-'987	1978-1979	1981-1982	1986-1987	1978-1979	1981-1982	1986-1987	1978-1979	1981-1982	1986-1987
Argentina	-2.9	-7.8	-5.6	-0.9	-3.8	-3.4	-6.5	-14.3	-4.5	-3.4	-5.4	-2.0	-3.5 [d]	-5.0	-1.8
Bolivia	-2.8	-10.4	-2.8	-2.5	-3.5	..	-9.1 [d]	-11.8	-6.8	..	..	..	..	..	..
Brazil	-1.1	-2.5	-12.8 [e]	0.9	0.1	-1.2 [e]	..	-14.2	-10.8 [e]	..	-1.9	0.5 [e]	..	..	..
Chile	2.4	0.8	1.0	3.8	1.3	3.0	4.8 [f]	-1.3	-1.8 [e]	6.0	-0.9	0.6 [e]	1.0 [d]	-0.5 [g]	-9.5
Colombia	-0.1	-3.9	-1.3	0.3	-3.1	0.0	-0.2	-5.6	-1.1	0.8	-4.1	2.8	..	..	..
Costa Rica	-5.9	-1.9	-2.7	-4.2	-0.3	-0.1	10.6	-11.2	-1.0	..	..	..	..	..	-3.4
Côte d'Ivoire	..	..	..	..	..	..	-8.7	-12.3	-3.6 [h]	-6.2		-6.2	6.3 [h]	..	.. ..
Ecuador	-0.9	-4.6	-3.4	1.0	-1.0	1.1	-2.8	-6.7	-2.5 [e]	-1.0	-3.1	2.0 [e]	..	..	..
Ghana	-9.6	-7.1	0.3	-7.6	-5.2	2.0	..	..	..	..	..	..	..	..	..
Indonesia	-2.6	-1.9	-2.2	-1.5	-1.0	0.6	..	..	..	..	..	..	..	..	..
Jamaica	-12.8	-14.9	-1.4 [e]	..	-6.8	9.0 [e]	-13.8	-15.4	0.1	..	..	..	..	-0.4	-5.6
Kenya	-5.6	-7.8	-6.5	-3.9	-4.9	-1.9	..	..	..	..	..	..	..	..	..
Malawi	-8.8	-9.7	-7.3 [e]	-6.7	-5.2	-1.1 [e]	-11.7 [d]	-14.0	-7.5 [i]	-9.7 [d]	-10.4	-2.1 [i]	..	..	..
Mexico	-3.0	-11.1	-10.5	-1.4	-7.6	3.3	-7.4 [f]	-15.5	-15.9	-4.0 [f]	-8.9	3.6	..	..	..
Morocco	-10.1	-12.8	-8.8 [e]	-8.1	-9.1	-3.1 [e]	-10.7	-12.8	-4.0	..	..	1.8 [e]	..	..	..
Nigeria	-1.6	-7.4	-5.4	-0.4	-5.2	1.2	..	..	..	..	..	..	..	..	..
Peru	0.7	-3.5	-4.7	4.0	0.1	-2.7	-3.9	-7.0	-5.7	-0.8	-2.5	-2.8	..	..	..
Philippines	-0.7	-4.1	-4.0	0.1	-3.2	0.4	..	-7.0	-1.5	..	-6.1	5.1	..	..	..
United Rep. of Tanzania	-11.7	-7.2 [k]	-5.5 [i]	-10.4	-5.1 [k]	-3.5 [i]	..	..	..	..	..	..	..	..	..
Uruguay	-0.3	-5.3	-1.4	0.4	-4.6	0.2	0.5 [d]	-6.1 [g]	-1.3	..	..	..	0.0	-8.3 [g]	-4.6
Venezuela	-1.1	-2.9	-0.6	0.3	-0.8	3.0	-4.8	-5.3	-6.1 [e]	-3.4	-0.5	-0.9 [e]	..	..	..
Zaire	-7.9	-10.1	-7.2	-5.7	-6.2	-2.5	..	..	..	..	..	..	..	..	..

Source: UNCTAD secretariat calculations, based on international and national sources.

a Includes all government and public enterprises; excludes central bank losses.

b The primary deficit equals the total deficit less interest payments.

c PSBR: public sector borrowing requirement.

d 1980.

e 1986.

f 1979.

g 1982.

h 1984.

i 1985.

k 1981.

58. Net transfers moved negatively in most countries between 1981-1982 and 1986-1987. The average change was 4 per cent of GDP - a high figure in view of the fact that the budget generally did not exceed 20 per cent of GDP. Real government revenues would have had to rise by more than 20 per cent over the period (4 per cent per annum) to allow that change to be covered without cutting real government domestic spending (i.e. total real government spending minus interest payments abroad), or engaging in monetary expansion or increased domestic borrowing.

59. The severity of the fiscal burden can also be gauged by the proportionate cuts in real government domestic per capita spending needed, in the absence of revenue increases, to accommodate the swings in resource transfers without resorting to money creation or increased domestic borrowing. That figure was, on average, one third in countries where transfers were reduced or reversed in direction. To have accomplished that without reducing public investment would have, on average, required halving currrent non-interest spending - an impossible task for any government.

2. Fiscal adjustment in the 1980s

60. While the extent of fiscal adjustment varied almost everywhere, policy action had by 1986-1987 reduced budget deficits and/or the PSBR to levels below those of 1981-1982. In the highly indebted countries taken as a group, the PSBR was reduced to 4.5 per cent of GDP and, more important, the primary balance of the central budget swung from deficit into surplus by 4 per cent of GDP; in some countries the swing in the primary deficit was 10 per cent of GDP or more. Indeed, in the majority of debt-troubled countries the primary budget was in surplus during 1986-1987 for both the central government and the public sector as a whole.

61. Table 3 shows that there are a number of common features in countries' fiscal adjustment since the early 1980s. In the first place fiscal adjustment involved mainly spending cuts rather than revenue increases. In the few countries where revenues rose, this was generally due to increased prices of public sector goods and services; with few exceptions, tax revenues declined or were constant. Second, interest payments rose almost everywhere, while primary spending was generally cut - in half the cases by 5 per cent of GDP. Third, while current non-interest expenditures (including public administration, social spending and transfers) declined, the brunt usually fell on capital spending, which was more than halved in a number of countries.

62. In many developing countries, the fiscal retrenchment achieved has been much greater than that accomplished by the major OECD countries during the same period. Although the need for fiscal adjustment has also been greater, it has had to be undertaken under extremely unfavourable circumstances. In the major seven OECD countries, average budget deficits in 1986-1987 were lower by only 1.5 per cent of GDP than in the highly indebted countries taken together. Cuts in budget deficits between 1981-1982 and 1986-1987 barely reached 0.5 per cent of GDP even in countries such as the United Kingdom, where reducing the deficit was a major goal of fiscal policy.

3. Financing of deficits

63. The PSBR in most highly indebted countries was only marginally higher (half a percentage point of GDP) in 1986-1987 than in the 1970s, even though interest payments were much higher (3 percentage points of GDP). However, because of cut-backs in external lending, the PSBR had to be financed domestically. This, in combination with increased central bank losses, either raised monetary expansion with attendant inflationary consequences, or the domestic indebtedness of the public sector, or both.

64. In the majority of countries the central bank financed an important proportion of the PSBR. Many others, however, have witnessed an unprecedented pace of domestic debt accumulation. This experience is closely related to the external debt crisis. Increased interest payments abroad made it very difficult to reduce the PSBR despite drastic cuts in primary spending. The resulting acceleration of inflation and the rise in domestic interest rates have threatened to set off a dynamic process in which higher interest rates feed into a larger public deficit which in turn results in a domestic debt explosion and still higher deficits (see section F below).

Table 3

FISCAL ADJUSTMENT FROM 1981-1982 TO 1986-1987 IN SELECTED DEVELOPING COUNTRIES

(Change as a percentage of GDP)

Country	Fiscal component					
	Total revenue [a]	*Tax revenue*	*Total expenditure*	*Interest payments*	*Current non-interest expenditure*	*Capital expenditure*
Public sector [b]						
Argentina	3.1	2.3	-6.7	-6.4	0.9	-1.2
Bolivia [c]	4.5	5.4	-5.0	..	..	-3.0
Brazil [d]	-2.7	-3.4	10.6	17.6	-4.8	-2.2
Chile [e]	1.3	-0.6	1.8	2.0	-2.7	2.5
Colombia	-4.4	1.0	-8.9	2.4	-11.8	0.5
Costa Rica	7.2	0.3	-3.0	..	..	-2.7
Côte d'Ivoire [f]	2.0	-2.3	-6.7	3.8	-2.6	-7.9
Ecuador [e]	-0.7	0.4	-4.9	0.9	-2.9	-2.9
Malawi [d]	0.1	0.1	-6.4	1.8	-1.0	-7.2 [g]
Mexico	5.0	0.6	4.1	10.6	-1.3	-5.2
Peru	-10.5	-3.0	-11.8	-1.6	-6.8	-3.4
Philippines	0.0	0.7	-5.5	5.7	-7.1	-4.1
Uruguay [e]	0.5	0.4	-4.3	..	..	-2.1
Venezuela [e]	-4.0	-2.5 [h]	-3.2	0.4	-1.4	-2.2
Central government						
Ghana	8.7	7.2	1.3	-0.2	0.8	0.7
Indonesia	-1.9	-3.4	-1.6	1.9	0.0	-3.5
Jamaica	3.5	..	-10.0	2.3	-7.4	-4.9
Kenya	-0.7	-1.9	-2.0	1.7	-1.5	-2.2
Morocco	-2.3	0.6	-6.3	2.0	-3.0	-5.3
Nigeria	2.1	..	0.1	4.4	-0.3	-4.0
Zaire	-7.0	-5.4	-9.9	0.8	-7.4	-3.3

Source: UNCTAD secretariat calculations, based on international and national sources.

a Including grants.

b Excluding the central bank.

c Total revenues and expenditures exclude state economic enterprises.

d Change between 1981-1982 and 1985.

e Change between 1981-1982 and 1986.

f Change between 1981-1982 and 1984.

g Development expenditures.

h Non-oil taxes.

C. Payments adjustment and fiscal balances

1. Conflict and consistency between payments adjustment and fiscal adjustment

65. The public sector's role as an exporter has been a major determinant of the ease or difficulty of servicing external debt without adding to domestic fiscal imbalances. In countries where public ownership in export sectors was important and such exports were expanding, governments could cover at least part of the deterioration in the balance of financial transfers without having to tax the private sector or lower public spending. By contrast, where the export expansion took place in the private sector, payments adjustment involved many problems on the fiscal front. Governments that succeeded in inducing an increase in private sector exports but failed to tax the additional export earnings to pay for debt servicing had to cut their spending or increase domestic borrowing and/or monetary expansion; since taxing exporters can serve to deter improved export performance, a trade-off emerged between export and fiscal performance.

66. An increase in private sector export receipts raises tax revenues if imports and incomes also increase. However, troubled debtors are not guaranteed such an outcome. If foreign creditors may reduce new lending on the grounds that the increased export earnings have lessened the need for borrowing, the government has to take restrictive measures in order both to prevent an increase in imports and to offset its own loss of financing. If it is unable to do so by taxing the gain accruing to exporters, other segments of society will have to bear a higher tax burden - something that is politically especially difficult to accomplish in the face of rising export earnings. Thus, if private creditors keep the level of new lending to the bare minimum, improved export performance can exacerbate distributional conflicts and accentuate macroeconomic disorder instead of bringing relief.

2. Trade policy, trade taxes and government revenues

67. The impact of trade shocks and payments adjustment on the fiscal balance is especially marked in developing countries because taxes on international trade and transactions are an important source of revenues - on average, 5 per cent of GDP and more than a quarter of total tax revenues. Import duties are the main source but export taxes are also important in countries exporting agricultural commodities. Trade taxes are particularly more important in low-income countries.

68. Thus, while the fiscal stance may be an important determinant of the trade balance, the trade balance itself is a major infuence on the fiscal balance. Indeed, swings in the fiscal balance have generally tended to follow rather than lead movements in the trade balance.

69. Government revenues from trade taxes are determined by (a) the volume and prices of imports and exports ("the trade performance"); (b) tax rates on traded goods ("the degree of trade liberalization"); and (c) the real value of the trade tax base in terms of domestic currency ("the real exchange rate"). Given the tax and exchange rates, increases in imports and exports both generate higher government revenues. Thus, an improvement in the trade balance will improve the fiscal balance if it is attained at a higher level of both exports and imports, but not if it is accomplished through import cuts. Government revenues will be adversely affected even if import cuts are accompanied by some increases in export earnings, since tax rates are typically much higher for imports than exports. Trade liberalization can alter the fiscal balance in either direction. Government revenues rise when import quotas and quantitative restrictions are replaced by tariffs, but fall when tariffs are reduced, especially if the consequent rise in propensity to import is counteracted by deflation and import levels are cut. Similarly, cuts in export taxes tend to lower government revenues.

70. Implicit average tax rates on imports have varied substantially among countries, ranging from 5 per cent to 25 per cent. On average, there was a moderate decline between 1980-1981 and 1985-1986. In the majority of the highly indebted countries the fall largely reflected tariff reductions. In most countries where the implicit average tax rate fell, quantitative restrictions had

already been replaced by tariffs during the 1970s; in the 1980s, the emphasis has been on tariff reductions. However, in many countries at lower levels of income, trade liberalization in the 1980s has centred around replacement of quantitative restrictions by tariffs; this has helped strengthen government revenues.

71. For a sample of 20 debt-troubled countries, government revenues from import taxes fell by 1 per cent of GDP between 1980-1981 and 1985-1986 because of import cuts and tariff reductions. Similarly, declines in the implicit average effective tax rates on exports, together with poor export performance, have reduced the average share of export taxes in GDP (at constant prices and exchange rates, not allowing for the effects of real depreciations). Declines in commodity prices in world markets accounted for the entire fall in export earnings, and its adverse impact on government revenues. If the 1980-1981 price levels had been maintained, in a number of countries export tax receipts during 1985-1986 would have been higher by between 0.4 and 0.8 per cent of GDP.

72. Trade policies, import cuts and commodity price declines in the 1980s together inflicted revenue losses averaging 1.5 per cent of GDP. This was mostly due to imports cuts, but reduced tax rates on trade were also important in a number of countries. Many governments in developing countries have therefore been reluctant to lower tariffs despite strong outside pressures on them to do so.

3. Currency depreciation and fiscal balances

73. Real currency depreciation may help improve trade performance, but its overall impact on the fiscal balance is generally negative. Devaluations can reduce government revenue by intensifying inflation and/or lowering activity (see below). Although they increase government revenues from trade and trade taxes, they also raise the real value of debt-service payments abroad and real spending on tradeable goods.

74. Currency depreciations have, indeed, exerted a significant positive influence on fiscal balances in a number of countries where trade taxes were an important source of revenue. However, with very few exceptions, they could offset only part of the revenue losses stemming from declines in tax rates, import volumes and commodity prices discussed above. Consequently, the share of trade tax revenues in GDP (at current prices and exchange rates) fell between 1980-1981 and 1985-1986 in most developing countries.

75. Real depreciation tends to redistribute domestic income in favour of export sectors and raise the real domestic currency value of interest payments abroad. During 1980-1981 and 1985-1987 increases in the real burden of interest payments from this source in most highly indebted countries reached or exceeded 1 per cent of GDP. The additional burden was also heavy for some low-income countries. In many countries in both groups the domestic currency value of interest payments in real terms rose by over 40 per cent.

76. The impact of exchange rate changes has also depended on the level of net foreign borrowing by the public sector. Where this has exceeded interest payments (i.e. where net external transfers to the public sector were positive), devaluations have improved the fiscal position. In many low-income countries (where the link between the budget and external financial flows is very close), net external transfers to the public sector have remained positive, and in some of them real depreciations have improved the fiscal balance; however, the benefits were partly offset where external borrowing necessitated provision of counterpart funds. In countries with negative net transfers, currency depreciations have made it necessary for governments to mobilize, on average, an additional 0.5 per cent of GDP to finance the net transfer.

77. Currency depreciation raises the real domestic currency value of government spending on tradeable goods by raising the cost both of intermediate goods imported by public enterprises and, more important, of public sector investment, which has a high import content. Public spending and public sector deficits would have been substantially lower if the 1980-1981 real exchange rates had been maintained.

78. A number of conclusions emerge when these various effects are put together. Where the government derived much of its revenues from the non-traded goods sector while spending heavily on traded goods and debt servicing, real depreciations worsened the fiscal balance. This was gen-

erally the case except where public ownership in the export sector and trade taxes were important, where net outward transfers were small (or where the net transfer was inward), and where public investment was modest in size. In many highly indebted countries total government revenues from international trade are around 2 per cent of GDP, whereas the interest payments abroad plus imports for public investment add up to about 6 per cent. Consequently, a real depreciation of 10 per cent raises the budget deficit by 0.4-0.5 per cent of GDP. In fact, many such countries have depreciated by more than 30 per cent since the early 1980s. "Realistic" exchange rate policies have thus been an important factor behind the "fiscal laxity" widely observed.

4. Overall effects of trade and trade measures on budget deficits

79. Table 4 brings together for a sample of countries the various influences exerted by changes in trade performance and trade measures on fiscal deficits already discussed. These figures do not include the effects of changes in government revenues from oil and non-oil commodities directly exported by the public sector. Losses of revenues from trade taxes resulting from import cuts, declines in export prices and tariff reductions represented, on average, about 40 per cent of the budget deficit actually incurred in recent years. In a few countries the effects were minimal, generaly because trade taxes were unimportant.

80. In most countries currency depreciations increased trade tax revenues by less than they raised the cost of real government spending, especially where the level of public investment was high and net transfers negative. In many low-income countries they had either a positive or a small negative impact because trade tax receipts were high relative to interest payments abroad. Nevertheless, almost everywhere currency depreciations together with changes in trade taxes brought budgetary losses. For the highly indebted countries included in the table, such losses amounted to about two thirds of the average budget deficit incurred during 1985-1986, in six countries for about one half, and in another three to more than the entire deficit.

81. Changes in export earnings affected fiscal balances differently in countries where public sector exports were important. In Chile the budgetary impact of the fall in copper earnings was more than offset by a sharp depreciation; indeed, the net fiscal gain from this source exceeded the adverse effects of trade taxes and currency depreciations (see the final column of table 4). In Mexico, however, the oil price collapse of 1986 brought government export oil revenues below interest payments; devaluation therefore increased the budget deficit. The fall in government revenues from oil was particularly steep in Indonesia, Nigeria and Venezuela, and currency depreciations served to offset them only in part.

D. Fiscal and monetary consequences of market-based menu operations

82. As was pointed out in chapter I, several of the items on the "menu" of options open to creditors tend to increase the difficulties of monetary and fiscal management in developing countries. These facilities require generation of resources in debtor countries by the public sector, which is not often possible without further deflation and/or price instability.

83. The macroeconomic implications of debt-equity swaps depend on whether they represent the sale of equity in existing public enterprises (e.g. in the context of a privatization programme) or new investment. In the first case the conversion has no fiscal or monetary repercussions. But when the conversion involves new investment or purchase of equity in existing private enterprises, it has much the same fiscal and monetary impact as deficit spending. Both types of debt conversion reduce interest payments by the public sector over time, but if the equity is generated by privatizing profitable public enterprises, there will be a revenue loss. If, on the other hand, the conversion is financed by issuing government paper, external debt will have been translated into domestic debt, exerting pressure on interest rates. Since in many debtor countries domestic debt carries higher real interest rates than external debt, this can lead to a deterioration of the fiscal balance. Debt conversion can also easily become a source of financial instability, given the size of the external debt compared to that of domestic money and credit markets: in many debt-troubled countries external debt is now more than 15 times the size of the monetary base.

Table 4

EFFECTS IN 1985-1986 OF CHANGES IN TRADE TAX REVENUES AND OF CURRENCY DEPRECIATIONS SINCE 1980-1981 IN SELECTED DEVELOPING COUNTRIES [a]

(Percentage of budget deficit)

	Increase in deficit due to:		
Country	*Trade effect* [b]	*Currency depreciation effect* [c]	*Total effect*
Argentina	6.0	32.0	38.0
Brazil	4.2	3.4	7.6
Chile [d]	2.1	127.3	129.4
Colombia [d]	33.3	16.7	50.0
Côte d'Ivoire [e]	153.1	12.5	165.6
Ecuador [d]	37.5	10.0	47.5
Ghana [d]	100.0	-433.3	-333.3
Indonesia [d]	31.6	57.9	89.5
Kenya	27.8	1.9	29.6
Malawi	16.6	5.6	22.1
Mexico [d]	35.9	15.5	51.4
Morocco	32.1	7.2	39.2
Nigeria [f]	92.3	13.5	55.8
Peru	46.4	3.6	50.0
Philippines	23.6	2.9	26.5
United Rep. of Tanzania [g]	24.4	0.0	24.4
Uruguay	88.9	16.6	105.5
Venezuela [d]	8.3	50.0	58.3
Zaire	34.9	-9.3	25.6

Source: Tables 33-37.

a A negative sign indicates a decrease in the deficit.

b Effects of changes in trade taxes due to changes in implicit average effective tax rates, trade volumes and prices from 1986.

c Effect of currency depreciation in real terms on trade taxes (tables 33 and 34), interest payments abroad by the public sector (table 36 adjusted for the estimated shares of the public sector in total interest payments on public and publicly-guaranteed debt), and import cost of public investment (as defined in table 37).

d 1985-1987.

e 1984.

f Effects since 1978.

g 1985.

84. "Relending" and "onlending" after a certain size can also give rise to important macroeconomic problems. When the original borrower is the public sector and the new borrower is the private sector, relending can give rise to a budgetary transfer problem. Similarly, onlending allocates new money to the private sector, while old debt is serviced by the public sector.

85. Under the present crisis conditions in debt-troubled countries, there is a serious risk that many of the mechanisms of the market-based menu can become an additional source of financial instability and capital flight. They open up new prospects for arbitrage, speculation and windfall profits for a handful of operators in creditor and debtor countries, giving them an interest in the persistence of the crisis. The extent of macroeconomic disorder makes it very difficult to design an appropriate mix of policies to deal with their destabilizing influences. Even if such mechanisms reduce outward transfers they can be very costly in terms of increased financial instability and austerity, conflicting with the prime objective of debt reduction. Many governments have therefore been reluctant to agree to such operations as part of debt rescheduling deals. Nevertheless, creditor banks have acquired substantial rights to engage in them.

E. Stagflation, government revenues and domestic debt

86. In order to avoid cuts in spending or an increase in the budget deficit, governments in debtor countries would have had to increase revenues considerably. For the highly indebted countries the increase in real revenue required to maintain the level of public spending (which implies a fall in per capital terms) was, on average, more than 5 per cent per annum for five years. Such an increase is extremely difficult to attain when GDP is contracting or growing very slowly.

87. Because of the very tight political and social constraints on their ability to raise taxes, debtor countries have generally found it much easier to finance resource transfers abroad by reducing investment than by cutting current consumption. They have also found it even easier to print money, since it avoids coming into direct confrontation with certain classes and groups and making explicit choices as to the distribution of the cost of adjustment.

88. The scope for improving efficiency of public enterprises has been reduced by cuts in investment, while reducing employment in the public sector has proved very difficult for many governments, particularly since economic activity has been depressed and real wages falling. Governments have consequently resorted to increases in public sector prices and reduction or elimination of subsidies. However, these have often played a key role in triggering an inflation spiral.

89. More important, many governments have been unable or unwilling to implement the tax reforms needed for an orderly adjustment. Taxes on private incomes, profits and capital gains have continued to remain remarkably low, barely exceeding 3 per cent of GDP in most debtor countries. In some countries private firms have paid less in taxes than they have received in the form of investment and export subsidies. One of the main reasons for the weakness of government performance on the revenue front has been the fear that raising taxes on the wealthier classes would be inimical to initiative and enterprise, and encourage capital flight.

90. Cuts in public spending have been costly for growth (and consequently for public revenues as well). Failure to maintain such infrastructure as transport and communications and education often results in major bottlenecks for the private sector, reducing profitability, output and the tax base. In many developing countries the complementarities between public and private investment due to supply-side linkages are strong. The contractionary effect of public investment cuts are therefore magnified.

91. Accelerating inflation has also tended to reduce real tax revenues because of the tax treatment of interest payments by the private corporate sector and lags in the collection of taxes: in many developing countries, interest payments by the corporate sector are deducted from taxable income. These losses have not been fully recuperated by taxing interest incomes. Not only have tax rates on interest earnings been kept low (for reasons already explained), but an important part of interest payments by the corporate sector in some countries has accrued to foreign creditors who cannot be taxed. In countries with progressive income taxation, tax revenues tend to rise faster than income and where taxes are also withheld at source, an acceleration of inflation can raise real tax revenue. In many developing countries, however, tax rates are not especially progressive and collection lags are relatively long. Consequently, when inflation accelerates, real tax revenues tend to fall. (For instance, a three-month collection lag implies a decline of about 15 per cent in the real value of tax receipts where monthly inflation is 5 per cent, and up to 50 per cent if it is 20 per cent.)

92. Inflation also added substantially to budget deficits and the PSBR by raising interest payments on domestic debt, forcing governments to contract new debt. In a number of countries there was a massive increase in domestic public sector debt relative to GDP. This was partly because primary deficits in earlier years and net external transfers from the public sector had not been covered by government revenues and central bank financing, but sharp increases in real interest rates also played a major role. As government paper was competing mainly with assets denominated in foreign currency, real interest rates were governed by expectations regarding the external value of the currency as well as the perceived risk of government debt. Commitments by governments to service external debt made it necessary for them to pay higher interest rates on domestic debt to overcome fears that such commitments would be honoured by taxing domestic asset-

holders or even defaulting on domestic debt. Moreover, where the currency was expected to depreciate, the real rate of return on government domestic debt measured in domestic currency had to be raised accordingly.

93. In general, when the real rate of interest on domestic debt exceeds the real growth rate, domestic debt rises relative to GDP even if the rest of the budget is balanced (i.e. non-interest spending plus public-sector net transfers abroad are covered by government revenues). The debtor countries are, therefore, confronted with a serious dilemma. When the payments crisis requires real interest rates to be kept higher than the real growth rate, surpluses are needed in the rest of the budget in order to avoid a domestic debt explosion. If tax revenues do not rise continuously, these surpluses have to be obtained by continuous cuts in public services and investment - something that reduces welfare and output growth, as well as the tax base. In any event, it is not possible to keep allocating an ever-increasing proportion of tax revenues to servicing foreign and domestic debt.

94. To generate and maintain a primary surplus while keeping domestic real interest rates at a sufficiently high level to stem capital flight and also avoid a debt explosion, therefore, requires a reduction of the external debt burden, a rise in the rate of growth of GDP and a substantial reduction in inflation.

F. Conflicting claims and inflation

95. As in the OECD economies during the 1970s, the acceleration of inflation in many debt-troubled countries in the 1980s has reflected, in large part, the increasing difficulty of reconciling income claims of different classes and groups. These difficulties were due to the supply shocks, followed by sharp devaluations and the collapse of growth. The pace of the acceleration has depended on the intensity of conflicts and the institutional mechanisms accommodating income claims. In many countries past inflationary shocks were perpetuated by indexation and inertia, and magnified by persistent efforts of various classes and groups to restore their pre-shock real incomes.

96. Inflation cannot accelerate indefinitely without monetary expansion, the main source of which is often the fiscal deficit. Nevertheless, the budget deficits and monetary growth in developing countries in recent years have been largely endogeneous and passive. Policies have not played an autonomous, independent and leading role in inflation; indeed, considerable efforts have been made to reduce fiscal deficits, as witnessed by the drastic cuts made in real primary spending. The persistence of large fiscal deficits has reflected difficulties of reconciling increased debt burden with resistance to increased taxation and to public expenditure cuts.

97. Moreover, in most countries there is no systematic relationship between the rate of inflation and the size of the public sector deficit as a proportion of GDP (the latter being a measure of resources claimed by the public sector over and above its revenues), even allowing for the fact that inflation itself tended to enlarge the deficit. In some countries inflation actually fell as deficits, including central bank losses, widened, and in many others it rose as deficits fell. Similarly, there was no systematic relationship between inflation and seignorage (as measured by increases in the monetary base as a percentage of GDP) inasmuch as the same amount of resources thus mobilized was associated with very diverse annual rates of inflation. Moreover, rates of inflation have been weakly correlated with the extent of the financing of public sector deficits from the central bank and of the increase of the monetary base (as a percentage of GDP).

G. Conclusions

98. There can be little doubt that the economies of many debt-troubled countries need stabilization. This would involve a considerable drop in inflation; moderation of public sector deficits; reduction in the pace of public domestic debt accumulation; substantial slowdown in monetary expansion; reduction and stabilization of real interest rates; stabilization of real exchange rates; and lessening of the degree of currency substitution and capital flight. These call for reconciliation of income claims, of which the reduction of public sector deficits is a part. Persistently high deficits, whether financed by an increase in the money supply or an unsustainable pace of domestic debt accumulation, reflect incompatibility of the claims on the budget made by various groups (such as public employees, rentiers, foreign creditors, recipients of government subsidies and beneficiaries of public goods) with the income transfers that the private sector is willing to make to the public sector through taxation. If this incompatibility is allowed to persist, the monetary expansion necessitated by the budget deficit can undermine efforts to achieve social consensus designed to limit increases in prices and wages, particularly where imports cannot be increased. Any attempt to reduce inflation by arriving at a generally acceptable pattern of income distribution must therefore include a consensus over fiscal measures and identify the sectors and social categories that will be most affected by fiscal consolidation.

99. Many developing countries are currently making renewed efforts with various combinations of orthodox and heterodox measures. Whatever the route chosen, success requires the rate of growth to be raised, otherwise the incompatibility of income claims will remain. As shown in *TDR 1988*, growth requires, *inter alia*, a substantial reduction in the debt burden.

100. While the need for debt reduction has now been recognized, it is still not sufficiently appreciated that, in a number of countries, restoring stability, order and confidence, and eliminating uncertainties and imbalances, will inevitably take time even if substantial relief is provided and appropriate policies are pursued by the debtor country. The crisis has been allowed to persist for so long that the cumulative damage is too deep-rooted to be undone swiftly. It would therefore be unrealistic, even counterproductive, either to require debtor countries to achieve a significant reduction in internal imbalances before becoming eligible for debt reduction, or to expect a swift return of stable conditions. The difficulty of attaining stability after a prolonged period of turbulance is demonstrated by the experience of the major OECD economies, which took almost half a decade to restore macroeconomic order after the mid-1970s, even when their external environment had improved.

101. Debt reduction can help reconcile income claims and eliminate disorder through two mutually reinforcing processes. It immediately releases resources for domestic use and, more importantly, it allows growth to be restored. Nevertheless, some elements of the current macroeconomic disorder will disappear only gradually, as negative impulses give way to positive ones.

102. Debt reduction will lower interest payments by the public sector, and so help to reduce budget deficits. However, public investment will need to be raised if debt reduction is to bring about faster growth. Fiscal adjustment will therefore need to be based on growth, and will thus take several years to complete. Current spending must nevertheless be kept under control and serious efforts made to raise the share of government revenues in GDP as the latter grows.

103. In countries where inflation is at three-digit levels and accelerating, negotiated prices and incomes policies will be needed, complemented by demand management, in order to attain a sharp drop in inflation. In some of these countries such policies have already been tried; their failure has stemmed, in part, from the paucity of external resources. Their lost credibility could be restored if debt reduction is sufficiently large and is utilized to serve as the catalyst for greater social cohesion.

104. Stability in real exchange rates can only be attained as the need to resort to currency devaluations is reduced through an investment in capacity to produce tradeable goods. Domestic real interest rates could then be reduced without triggering currency substitution and capital flight, since successive real devaluations would no longer be expected as a matter of course. Lower domestic real interest rates, faster GDP growth and a smaller PSBR could gradually reduce public debt relative to GDP; a reduced level of external debt would thus be translated into a lower domestic debt ratio. The resulting restoration of stability, growth and confidence would also encourage the repatriation of flight capital.

105. As has already been pointed out in *TDR 1988*, debt relief is not a "quick fix": substantial

policy efforts would continue to be necessary. Nevertheless, for the reasons given above, the attempts to achieve stabilization before reviving growth have yielded little. A strategy that sought to restore macroeconomic order in the context of growth would appear to offer much greater chances of success, in terms of both stability and growth.

UNITED
NATIONS

TD

United Nations Conference
on Trade and Development

Distr.
GENERAL

TD/B/C.3/235
16 February 1990

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Committee on Invisibles and Financing
related to Trade
Thirteenth session (second part)
Geneva, 30 April 1990
Agenda item 3

REVIEW OF INTERNATIONAL MONETARY AND FINANCIAL QUESTIONS RELATED TO TRADE AND DEVELOPMENT, INCLUDING, IN PARTICULAR, OFFICIAL DEVELOPMENT CO-OPERATION

The external financing of development

Report by the UNCTAD secretariat

GE.90-50360/1561B

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Annexes

Table 1 Net financial flows to developing countries, 1980-1988

Table 2 Net financial flows to developing countries in real terms, 1980-1988

SURVEY OF THE QUALITY AND USEFULNESS OF UNCTAD PUBLICATIONS AND OF THEIR END-USERS

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SUMMARY AND CONCLUSIONS

1. The 1980s witnessed far-reaching changes in the volume and structure of financial flows to developing countries as well as in the policies of official and private creditors. The most significant event was the halving of net financial flows, accompanied by an unprecedented reversal of net transfers to developing countries. This development resulted from a precipitous decline in private flows, especially bank lending, and growing interest payments on external debt. At the same time, official finance failed to offset even partially the fall in private flows. The collapse in external finance occurred at the time when developing countries had to adjust to a worsened trading environment.

2. These changes were inextricably linked to the unfolding of the debt crisis. After 1982, a close interaction emerged between the availability of external finance and the debt-servicing difficulties experienced by developing countries - particularly those heavily dependent on private flows. An initial decline in net financial flows exacerbated debt-servicing problems which, in turn, discouraged new inflows. Much hope was put on the revitalization of foreign direct investment. However, despite increased receptivity and debt-equity swap programmes, the recent slight increase in foreign direct investment did not meet these expectations. As long as the debt overhang persists, it is likely to continue to dampen foreign investment as well as other private flows to debt-distressed countries, including the return of flight capital.

3. The pervasiveness of the debt problem was such that debt rescheduling became an entrenched feature of the international financial system. At the same time, adjustment lending expanded considerably, with a growing volume of external finance, including bilateral ODA, becoming conditional on the macro-economic performance and structural reforms in recipient countries. Through this process, the IMF and the World Bank became linchpins of the development finance system.

4. The role played by the multilateral financial institutions (MFIs) in meeting the external capital requirements of the highly indebted middle income countries (HICs) has been disappointing. Since 1987, net transfers from the MFIs to HICs have become increasingly negative. This development - occurring at the time the HICs are transferring resources to the commercial banks to the tune of $20 billion annually - has wider systemic implications and challenges the ability of the MFI to adapt swiftly to the financial needs of countries threatened by the debt overhang. By contrast, the MFI played a major role in mobilizing and providing directly financial resources to low-income countries, particularly those in sub-Saharan Africa. Adjustment lending by the MFI has raised a number of questions regarding the approach and content of the programmes negotiated with these institutions, as progress achieved so far in adjustment and restoration of growth has been mixed. The financial roles, policies and terms of the Fund and the Bank became increasingly blurred at the margin. The time is ripe to review thoroughly the respective roles of the two institutions, to what extent overlapping is necessary, and to what extent their co-operation is appropriate to enhance their effectiveness, while minimizing undue pressures on borrowing countries.

5. During the 1990s, the system of international financial co-operation will confront a number of key challenges. One of the priorities is to support efforts to restore growth and macro-economic stability in developing countries afflicted by the debt overhang. This objective would require both policy reform and increased domestic resource mobilization in debt-distressed countries as well as a return to positive net financial transfers. For the next several years, these countries are not likely to be in a position to finance the increased investment necessary to resume sustained growth out of their domestic savings alone. Growth-oriented adjustment will thus require a much higher level of external financing. At the same time, the external capital needs of the developing countries that were able to avoid the debt crisis should not be neglected. Another challenge for international financial co-operation is the adequate financing of environmental programmes in developing countries. Furthermore, the international financial system will have to respond to the huge external capital requirements of the reforming countries in Eastern Europe in a way which will be compatible with strengthened financial support to developing countries. The recent and expected response of the OECD countries may carry a risk of diversion of flows from developing countries, especially as regards ODA. Every effort should be made to ensure true additionality.

6. In view of the increasing demand pressures on development finance, fundamental questions arise regarding the adequacy of the supply of development finance, whether official or private. Macro-economic performance of OECD countries is one of the key factors affecting such supply. The shortage of world savings and limited recycling efforts by surplus countries are important concerns in this regard. Official flows will continue to be the principal component of development finance in the 1990s since a substantial return of private capital to developing countries is unlikely, especially in view of the expected behaviour of commercial banks. But prospects for official development finance are poor, especially for ODA, whose supply is fully dependent on budgetary allocations. The outlook for non-concessional official finance is also unfavourable. An issue requiring attention is to what extent lending from MFIs to the HICs can safely increase in the absence of considerable additional reduction in commercial bank debt, without jeopardizing the MFIs' ability to provide adequate financing to other borrowers and the creditworthiness of the MFIs themselves.

Chapter I

DEVELOPMENT FINANCE IN THE 1980s

A. Overview

7. The 1980s witnessed far-reaching changes in the volume and structure of financial flows to developing countries as well as profound shifts in the policies of official and private creditors. The most significant event of the decade was the sharp fall in net financial flows, accompanied by an unprecedented reversal of net transfers to developing countries. By 1988, total net resource flows to developing countries had shrunk in real terms 1/ to half of the record volume reached in 1981 (table 2). The decline in net flows has virtually bottomed out since 1987. But this can hardly give rise to complacency, if it is gauged in the context of the financial stringency still facing the majority of developing countries. Since 1983, rapidly shrinking net financial flows - together with persistently high interest payments - led to the emergence of a net transfer of financial resources from developing countries to the rest of the world, which rose to an estimated $36 billion in 1988 (table 1). The bulk of this amount was accounted for by countries that could not afford to transfer resources abroad.

8. Another fundamental change in development finance was the sharp fall in private flows, and the concomitant rise in the share of official flows in the total. By 1988, this share had grown to two thirds, a proportion higher than that prevailing in the early 1960s, before the heavy borrowing by developing countries from commercial banks. But this shift was entirely due to the collapse of private flows, rather than to the expansion of official finance, which in fact virtually stagnated in real terms over the decade, and has been on a slightly declining trend since 1986.

9. These developments represent a complete reversal of the trends that prevailed in the 1970s, when net financial flows to developing countries rose rapidly, as a consequence of the huge expansion in commercial banks lending and, to a lesser extent, of growing official development finance. These changes in the level and composition of financial flows are inextricably linked to the unfolding of the debt crisis. Since 1982, a close interaction has been growing between availability of external finance and debt-servicing difficulties experienced by developing countries. Especially in those countries heavily dependent on private flows, this interrelationship created a vicious circle, whereby an initial decline in net financial flows exacerbated debt-servicing problems which, in turn, discouraged new inflows. The fall in net flows and the growing negative transfers were due to the collapse in commercial bank lending, export credits and foreign direct investment as well as to rising interest payments. All these factors are intimately related to the debt crisis of the 1980s.

10. The debt crisis had adverse consequences not only for private flows but also for official development finance. As an example, countries that were forced to build up arrears to the multilateral financing institutions because of their acute debt problems were barred from borrowing from these institutions. A number of donors applied the same policy to countries that had accumulated arrears on their bilateral debt. More important, deteriorating economic conditions in many highly indebted middle-income countries (HICs) and delays in policy-based loan negotiations negatively

affected the volume of non-concessional multilateral flows which sharply declined in real terms after 1984. By the late 1980s, net transfers from the World Bank to all developing countries had turned negative, especially those to the HICs. However, the adverse impact of the debt crisis on financial flows was somewhat attenuated by the efforts made by the World Bank and the IMF to raise additional funds particularly for debt-distressed sub-Saharan African countries.

11. The debt crisis explains other important features that characterized development finance during the 1980s, namely debt rescheduling and adjustment lending. The pervasiveness of the debt problem was such that debt rescheduling, once an isolated, one-off mechanism designed to overcome a temporary liquidity problem, became an entrenched feature of the international financial system. During the period 1986-1988, as many as 72 developing countries incurred external payments arrears or entered official or private debt rescheduling agreements. Debt rescheduling provided, on average, a cash flow relief of $40 billion a year - equivalent to one quarter of actual debt-service payments by all developing countries. For the 15 HICs, exceptional financing - that is rescheduling and accumulation of arrears - represented as much as 3.7 per cent of GDP during the period 1983-1988.

12. The increased level of rescheduling activity was itself a symptom of the inadequacy of net financial flows to developing countries and of the acute debt-servicing problems faced by many of them. Furthermore, traditional rescheduling techniques which prevailed until 1988 only tended to postpone and, in most cases, to amplify the debt problem. Indeed, recent policy initiatives - the Toronto Agreement on official debt relief and the Brady Plan for commercial bank debt - reflect awareness of this weakness and contain measures designed to reduce the stock of debt. 2/

13. Concomitant with the increased frequency of debt restructurings, adjustment lending expanded considerably, with a growing volume of external assistance, including debt rescheduling, becoming conditional on the macro-economic performance and structural reforms in recipient countries. In the evolution of adjustment lending and the associated policy dialogue, a number of fundamental questions have arisen concerning the scope of this dialogue and the necessary conditions for securing its success. Through the process of adjustment lending and its linkage to debt reschedulings, the IMF and the World Bank became the linchpin of the development finance system, and non-project financial assistance played an increasingly important role in both multilateral and bilateral activities.

14. Capital flight was an additional factor that adversely affected external resource availability in the 1980s. Although capital flight appears to have declined significantly over the past few years, it is a manifestation of financial disorder and again intimately linked to the debt-servicing difficulties experienced by developing countries. Capital flight is thus unlikely to be reversed in a significant fashion until a durable solution to the debt crisis is found.

15. The collapse in external finance occurred at precisely the time when debt-distressed countries had to adjust to a worsened trading environment characterized for most of the decade by deteriorating terms of trade and slow or negative growth in export volumes. As a consequence, the HICs, and to a larger extent the sub-Saharan African countries lost much of their export

purchasing power during 1982-1988. The situation has improved somewhat for the less commodity-dependent HICs since 1987, as they were able to more than offset a deterioration in the terms of trade with robust growth in export volumes.

16. Faced with a sharp fall in net flows, rising interest payments and reduced purchasing power of their exports, debt-distressed countries had no alternative to cutting back imports, especially of capital goods, with adverse consequences on investment and growth, which further weakened their debt servicing capacity. By 1988, import volumes in the HICs had dropped more than one third below the 1981 level; investment had declined by 5 percentage points of GDP; and per capita income had shrunk by some 5 per cent. In sub-Saharan Africa, the combined fall in export purchasing power and resource flows was less pronounced than in the HICs, but this occurred from lower levels. The cutbacks in import volumes and investment were of the same order of magnitude as those experienced by the HICs. The ensuing decline in per capita income was, however, higher (15 per cent).

17. The global trends described above had an uneven impact on the various economic and regional groups of developing countries. The negative transfer of resources of developing countries as a whole is largely concentrated in the 15 HICs which have been particularly affected by the contraction in private flows and by the rise in interest rates. For this group, net transfers dropped sharply from a pre-crisis average of 2 per cent of GDP in 1979-1981 to a low of -4 per cent in 1984-1985 and a level of -2 per cent since. Net transfers are the counterpart of the external trade balance on goods and non-factor services. The HICs have in fact effected a huge external adjustment, which has involved the generation of very large trade surpluses, in order to meet interest payments in the context of extremely low and declining net flows. The swing in net transfers and the corresponding external adjustment has been particularly pronounced in Latin America. During 1982-1988, the region experienced negative net transfers equivalent to 4 per cent of GDP, against positive transfers averaging 2.7 per cent of GDP during 1973-1981.

18. Net resource flows to sub-Saharan Africa have risen in real terms since 1985 but not enough to offset their 30 per cent drop between 1982 and 1984. In 1988, total net flows still remained somewhat below the peak reached in 1982. Bilateral and multilateral donors stepped up their ODA to the region. At the same time, there has been a virtual collapse of private lending. ODA now represents about 70 per cent of total flows. Aggregate net transfers remained positive, albeit reduced. However, for a number of debt-distressed countries they became significantly negative.

19. In Asia, the financial picture has become increasingly complex and varied. Unlike the situation in Latin America, negative transfers in some Asian economies - for example the Republic of Korea and Taiwan Province of China - have been a sign of growing economic maturity associated with a strong trade and savings performance. A number of countries in South-East Asia spontaneously reduced their reliance on external finance - while maintaining positive transfers - as a consequence of enhanced export capacity and prudent borrowing policy. By contrast, India and China became large absorbers of external finance, particularly private flows.

B. Official development finance

20. During the 1980s, official development finance - comprising bilateral and multilateral flows, both concessional and non-concessional - remained practically constant in real terms. And yet, by the end of the decade it had become again the mainstay of financial co-operation for development, with its share in total flows rising from 36 per cent in 1980 to 66 per cent in 1988 - albeit in the context of sharply reduced overall net flows (table 1). The increasing dominance of official finance was more pronounced in Latin America, the region which suffered the most from the cutback in private flows.

21. Within official development finance, bilateral assistance grew more rapidly than multilateral flows, especially since 1985, thus reversing an earlier trend towards increased multilateralism. By 1988, bilateral flows had risen to about half of total net flows. Since 1984, concessional flows expanded faster than non-concessional assistance, thus improving the terms of official development finance and of aggregate net flows.

1. Official development assistance

(a) Aid volume

22. Official development assistance has remained the backbone of development finance, accounting for half of total net flows in 1988. It has therefore been a matter of concern that concessional flows virtually stagnated in real terms during the 1980s. They rose somewhat in 1984 and 1985 as a response to the emergency needs in Africa, and then declined by 3 per cent annually through 1988. The slightly upward trend in ODA provided by DAC countries and the socialist countries of Eastern Europe was not sufficient to offset fully the sharp fall in OPEC aid. The recent decline in global ODA took place at a time when low-income countries were confronted with unprecedented financing needs caused principally by an unfavourable external environment and the debt crisis.

23. The bulk of ODA (84 per cent in 1987-1988) is provided by DAC member countries. Flows from these countries rose during the period 1982-1988 at an annual rate of about 2.3 per cent in real terms, an increase that roughly matched their GNP growth. Thus, DAC countries' aid effort - measured by the ratio of ODA to GNP - has not improved over the past decade remaining virtually constant at a level of 0.32 per cent, slightly less than half the internationally agreed target of 0.7 per cent. Looking at a longer period, DAC's aid performance in the 1980s was very similar to that of the 1970s, but much weaker when compared to the aid effort of the 1960s (0.50 per cent).

24. In 1987-1988, ODA flows from DAC countries to the least developed countries - at less than 0.1 per cent of their GNP - remained well short of the 0.15 target, despite the expansion registered over the past decade.

25. Trends in the individual performance of donor countries were mixed. Four donors (Denmark, Netherlands, Norway and Sweden) continued to exceed the 0.7 per cent target. Finland and Italy have increased ODA over the period 1983-1988 by more than 15 per cent annually. Canada, France and Switzerland have also strengthened their aid efforts during this period. Among major donors, however, the performance was less encouraging. The volume of ODA provided by the Federal Republic of Germany declined by nearly 2 per cent

annually over the past five years. Aid from the United States, still the largest donor, accounting for 20 per cent of DAC ODA, was practically constant in real terms. By 1988, its ODA/GNP ratio had declined to 0.21 per cent as compared to 0.31 in the early 1970s. ODA from Japan increased more rapidly than the DAC average but not faster than its GNP. Thus, Japan's ODA/GNP ratio has hardly improved since the early 1980s and is still below the DAC average. However, during the 1980s, Japan has become the second largest donor making the largest single contribution (about 30 per cent) to the aggregate increase in DAC ODA. It is worth noting that aid appropriations as a share of the Government budget have remained remarkably stable for the DAC countries as a whole and for the majority of its members. In the United States, however, the share of aid in total federal expenditure fell by almost one half in the late 1980s.

26. Concessional flows from OPEC countries declined sharply during the 1980s, in the face of the collapse of oil prices and mounting financial difficulties of the donor countries themselves, which have been running aggregate current account deficits since 1982. These flows had reached the peak level of about $14 billion (at 1987 prices and exchange rates) in 1975, accounting for more than a quarter of world ODA. They ran over $10 billion until 1981, and have since declined to about $2 billion in 1988. This drop also reflects the rapid contraction in the number of donors, now largely confined to Saudi Arabia and Kuwait, which provided, respectively, 3.3 per cent and 0.8 per cent of their GNP in ODA for 1988.

27. The volume of development assistance reported by CMEA countries has been growing in recent years. Assistance reported by the USSR, providing roughly 90 per cent of the total, rose from 1 per cent of GNP in 1976-1980 to 1.4 per cent in 1988.

28. The 1980s witnessed a major shift in the geographical distribution of aid toward sub-Saharan Africa, which now absorbs about 30 per cent of global aid. At present, about 8 per cent of sub-Saharan GDP is provided, on average, by ODA. At the same time, there was a decline in the shares of South Asia and - to a larger extent - of North Africa and the Middle East in the total. Some donors continued to have a pronounced country concentration, reflecting more their political, security or trading concerns than a poverty focus. 3/

(b) Aid effectiveness

29. Even taking an optimistic view, ODA will remain an extremely scarce resource. It is, therefore, natural that policy makers - in both developed and developing countries - should wish to ensure that the quality of aid make the maximum possible contribution to the development process. Aid effectiveness covers a number of issues related to donors' policies, recipients' actions and policy dialogue between donors and recipients within the context of aid co-ordination. In the 1980s, fundamental changes occurred in aid relationships, as key areas of macro-economic and sectoral policy formulation came under donors' intensified scrutiny in the framework of structural adjustment programmes financed by the Bretton Woods institutions. A much closer link was established between the provision of aid and recipients' adjustment efforts, which many donors today view as an essential ingredient for an effective use of aid, whether for projects or for quick disbursing balance-of-payments support, which has become increasingly important, in view of the foreign exchange stringency faced by many

recipients. In this context, a number of important questions have arisen as regards the role of the multilateral and bilateral institutions in the formulation of the adjustment programmes, as well as the right balance between project financing and programme assistance.

30. Improved aid co-ordination is a key element in achieving greater aid effectiveness, as well as in mobilizing a greater volume of resources to poor countries. A recent UNCTAD study 4/ assessed the aid co-ordinating role played by the consultative groups and round table meetings for the least developed countries (LDCs). The study identified four major problem areas in the aid co-ordination process, that may also affect - to varying degrees - developing countries other than the LDCs. First of these areas is the need for the LDCs and their development partners to focus on better formulated development strategies over a longer period. The current structural adjustment programmes have launched a number of important reforms but in a time frame and manner which is not well suited to the development needs of the LDCs. Second, as donors have been playing an increasingly prominent role in aid co-ordination, both directly and through the Fund-Bank policy framework, the role of LDC Governments has been relatively diminished in the process. Third, the development assistance programmes and practices of donor agencies are not effectively directed to building the institutional and managerial capacities of the LDCs. Fourth, while preparation and conduct of donor groups has been greatly improved, the follow-up is still the weakest point in the country review process.

31. This assessment points to the need for:

(a) Longer term and more integrated strategic planning as a basis for effective aid co-ordination. Donor groups should take a comprehensive approach to external capital requirements encompassing the need for debt relief and, thus, better co-ordination with the Paris Club, which has been in fact empowered to extend concessional assistance following the Toronto Agreement;

(b) Reciprocal undertakings between the LDCs and donors, including provisions for joint monitoring;

(c) Improvements in aid co-ordinating mechanisms aimed at enhancing the follow-up system and strengthening the central responsibility of LDC Governments, particularly in policy formulation and implementation; and,

(d) Redirection of assistance for more effective building of LDC institutional capabilities to co-ordinate and manage resources.

32. The last area mentioned above raises the broader issue of the overall effectiveness of technical assistance. DAC technical assistance, amounting to $10 billion in 1988, represents one quarter of total ODA provided by DAC member countries. For some donors, it accounts for as much as one half of their aid. Furthermore, about 50 per cent of DAC aggregate technical assistance expenditures consists of relatively high salaries of expatriate experts. For this reason, in some recipient countries technical assistance costs are as large as the wage bill of the whole central Government. As with

the co-ordination and delivery of capital assistance, technical assistance tends to be "donor driven". Both donors and recipients are aware of the urgent need to improve technical co-operation policies and procedures. The latest World Bank study on sub-Saharan Africa concluded: "most technical assistance is unco-ordinated, improvised, poorly managed, and rarely fitted into a comprehensive strategy for capacity building or institutional development". 5/ And the latest policy statement by DAC Aid Ministers reflected the same concern: "We recognize that the nature and quality of technical assistance will often have to be significantly rethought and upgraded to contribute better to longer-run institution-building requirements". 6/

2. Multilateral flows

33. The broad retrenchment in the supply of funds from market-related sources has focused attention on the role that multilateral financial institutions (MFIs) could play in financing adjustment and growth, especially in debt-distressed countries. The role of the MFIs in the debt crisis has raised a number of important issues, such as (a) their financial contribution to debtor countries' external capital requirements, (b) the success of adjustment lending, and (c) the increased interaction between the World Bank and the International Monetary Fund.

(a) The financial impact of multilateral institutions

34. In analysing the financial role of MFIs in the context of the debt strategy, it is useful to make a distinction between their contribution to resource flows to the HICs, mostly through non-concessional resources, and their financial impact on the low-income debt-distressed countries, mostly through the provision of concessional funds. The record of the MFIs in the HICs can be best assessed in the framework of the Baker Plan. Under that initiative, the multilateral development banks (MDBs) - that is the World Bank and the regional development banks - were expected to increase their net disbursements to $7 billion a year or to a total of $20 billion during 1986-1988, in order to match a similar amount expected from the commercial banks. In the event, net lending by the MDBs averaged somewhat less than $4 billion annually, or about the same nominal level as in 1983-1985. The World Bank experienced a sharp decline in net disbursements, from $3.4 billion in 1986 to $1.5 billion in 1988. Several factors have contributed to these results. Adjustment lending was delayed in a number of HICs, as a result of problems arising in the policy dialogue, such as differences between borrowers and the Bank over the pace and sequencing of adjustment measures. Uncertainties about the availability of aggregate financial resources to support the adjustment programmes also played a role. Disbursements on project lending were constrained by the lack of counterpart funds due to severe budgetary problems encountered by borrowing countries. At the same time, amortization of a growing stock of debt and exchange rate movements raised substantially the dollar value of repayments. When account is taken of interest payments, by fiscal 1988 the World Bank had become a net taker of resource from the HICs. In fiscal 1989, the net transfer from the HICs to the Bank grew to $1.9 billion. Moreover, this phenomenon was not limited to this group of countries, as the overall net transfer from current borrowers to the IBRD reached $2.6 billion.

35. The disappointing performance of MDB financing was compounded by the lending behaviour of the IMF. Over the period 1986-1988, annual net disbursements from the IMF to the HICs were a negative $1.1 billion, reflecting difficulties encountered by major debtors in concluding arrangements with the IMF as well as repayments of large borrowings made during the early 1980s. Thus, during the period covered by the Baker initiative, actual net disbursements from MFIs (that is MDBs plus IMF) declined sharply to $2.8 billion annually, as compared to $7.6 billion during 1983-1985. Aggregate net transfers from MFIs to the HICs started to turn negative in 1987 and the outflow reached $3.9 billion in 1988. One of the shortcomings of the Baker Plan was the failure to treat the MFIs in a consolidated fashion and to include the IMF in the initial allocation of the share of multilateral financing. The IMF is viewed as a revolving credit agency. However, a consolidated overview of the role of MFIs would have resulted in anticipated reflows to IMF being offset by higher disbursements from the MDBs.

36. Negative net transfers arising from MFI operations occur at the time the HICs are transferring resources to the commercial banks to the tune of $20 billion annually. This development thus has wider systemic implications and challenges the ability of the MFIs to adapt swiftly to the changing circumstances of their members and to finance adjustment programmes in countries threatened by the debt overhang. These issues are discussed in greater detail in chapter II.

37. In sharp contrast to the financial performance of the MFIs in the context of the HICs' debt crisis, these institutions played a major role in providing and mobilizing financial resources to low-income debtor countries. In December 1987, the World Bank launched a Special Programme of Assistance (SPA) for the debt-distressed low-income African countries during 1988-1990. The programme includes increased IDA lending, expanded co-financing, concessional and non-concessional debt relief by bilateral donors, 7/ supplemental IDA credits to offset partially debt service to IBRD by countries now eligible for IDA credits, a special IDA facility to finance repurchases of private debt, and access to the IMF's Structural Adjustment Facility (SAF) and Enhanced Structural Adjustment Facility (ESAF). The latter was established at the end of 1987 with IMF members' loans and donations. Together the SAF and ESAF can provide about $12 billion in medium-term concessional loans, mostly to African countries.

38. The multilateral support to low-income African debtors has resulted in a major increase in net disbursements by the MFIs from $5.7 billion in 1983-1985 to $9.1 billion in 1986-1988. Multilateral net disbursements have declined, however, in 1988 and 1989, reflecting a sharp contraction in IMF's overall lending. This means that SAF/ESAF disbursements have not fully offset large repurchases under earlier stand-by arrangements, thus defeating one of the very purposes of these facilities. It appears in fact that the higher conditionality embodied in the operations of ESAF, as compared to SAF, has been a deterrent to a broad, rapid use of this facility. Of the 62 eligible countries, only 11 had benefited from ESAF in the two years after its establishment.

39. Despite these shortcomings, the multilateral share of low-income Africa's external debt had grown to almost 40 per cent by 1988. The non-reschedulable nature of this debt has created difficult financial problems in many countries. A number of low-income debtors have accumulated large arrears to multilateral creditors and, thus, are not eligible for further multilateral financing and associated co-financing. Special efforts to clear arrears through the establishment of support groups sponsored by bilateral donors have so far had little success, mainly because they were underfunded.

(b) Adjustment lending

40. In the 1980s, many developing countries have carried out structural adjustment programmes, with the financial support and advice of the Bretton Woods institutions. Structural reforms prompted by external payments difficulties and supported by the MFIs have covered key areas, such as the trading system, public finances and enterprises, pricing policy, agricultural and industrial policies and the financial system. The implementation of the reforms has played a key role in the SAF and ESAF arrangements of the IMF. Since its introduction in 1980, quick-disbursing adjustment lending by the Bank has grown rapidly to the current level of about 25 per cent of new annual commitments. For the HICs, adjustment lending accounted for about half of the Bank's total commitments in fiscal 1989.

41. Adjustment lending has been widely debated in a number of forums. There is a broad agreement that progress in adjustment and restoration of growth has been mixed. The question of adjustment and reform in developing countries was also discussed by the informal group of competent personalities convened by the Secretary-General of UNCTAD in September 1989 in the context of the Trade and Development Board review of interdependence. The conclusions the Secretary-General drew from that discussion were the following:

> "There is now a wide consensus on the need to bring about thorough-going adjustment and reform in many developing countries, so as to adapt their economies to the requirements of a changed world economic environment. There is also wide consensus on at least some of the essential ingredients of the required adjustment and reform; for example, the fostering of a vigorous and competitive export sector capable of producing an appropriately rapid expansion of external earnings. Yet differences of view appear to remain regarding the means through which such changes can be brought about, and in particular as regards their pace. Particular attention needs to be paid to the interaction of sectoral reform with broader macro-economic objectives. For example, experience indicates that success in expanding exports generally require a remunerative and stable exchange rate, in real terms, and a relatively stable macro-economic environment. Success has also been associated with the provision of specific incentives for specific export activities, and with selective controls on imports. Macro-economic instability thus creates conditions in which sustained export expansion is unlikely to occur; moreover, in such circumstances export expansion could complicate macro-management and reduce welfare - for example by triggering a cut-back in new lending. This suggests that increased attention needs to be given to the interaction of measures to bring about longer-term reform and short- and medium-term macro-economic objectives.

It cannot be sufficiently emphasized that for all countries undergoing reform, and in particular those with a history of debt problems and poor growth performance, a prompt return to rapid growth is the highest priority. Adjustment programmes negotiated with the Bretton Woods institutions need to reflect fully this priority. Despite increased attention, it does not always appear that growth receives the required priority in programmes negotiated with the IMF." 8/

(c) IMF - World Bank interaction

42. In the 1980s, the financial roles, policies and terms of the Fund and the Bank became increasingly blurred at the margin. As a response to deep-rooted financial problems faced by debt-distressed countries, both institutions have shaped broadly comparable lending instruments centering around similar policy targets of a macro-economic and structural nature. With the debt crisis, the traditional distinction between long-term and short-term financial needs has lost much of its operational value for defining the respective roles of the Bretton Woods institutions. The overlapping of activities has been greater in the case of low-income countries, with the introduction of structural adjustment lending by the World Bank followed by the SAF and ESAF operations of the Fund.

43. The parallel involvement of the two institutions in structural adjustment has led at times to policy advice with differing thrusts, de facto cross-conditionality, and joint design of adjustment programmes with inadequate participation of recipient countries. In early 1989, the two institutions clarified the division of labour, the Fund maintaining primary responsibility for the aggregate aspects of macro-economic policies and their related instruments, while the Bank kept its hegemony over development strategies, sectoral policies and project investments, and policies dealing with the efficient allocation of resources in both public and private sectors.

44. Over the 1980s, cross-conditionality - a situation in which commitments and/or disbursements of one lending agency are made contingent on the borrowers reaching a satisfactory agreement with another agency - became an increasingly important feature of the international financial system in general, and of the IMF - World Bank interaction in particular. The view has been endorsed that the operations of the two institutions should not lead to formal cross-conditionality. However, the actual practice has resulted in a significant expansion in informal cross-conditionality, especially in low-income countries, through the linkage between World Bank's adjustment loans and the IMF facilities. In fact, 95 per cent of the countries that received World Bank structural or sector adjustment loans during 1980-1988 also had Fund programmes. The increased overlap of Fund and Bank operations in the context of adjustment lending has raised fears over "interdependent" cross-conditionality, whereby both institutions use the same policy variable as the principal element of their programmes. This practice has led to concerns regarding possible concerted pressure on the borrowing country and the emergence of a kind of "cartelization" among lenders, at a time of sharply reduced financial flows. A number of proposals for further interaction between the two institutions have recently been put forward. One authoritative suggestion envisages prior agreement between the Fund and the Bank before even discussing with the country concerned matters regarding conditionality on major issues. Such a proposal does not allay fears over cross-condititionality.

C. Private flows

45. The share of private flows (including export credits) in total resource flows shrank by half from 62 per cent in 1980 to 31 per cent in 1988. The debt crisis led to a collapse of commercial bank lending, as well as export credits. Much hope was put on the revitalization of foreign direct investment in order to compensate in part for the sharp drop in commercial bank loans; however, the slight increase in foreign direct investment which took place towards the end of the decade did not meet these expectations.

1. Commercial bank lending

46. The precipitous fall in commercial bank lending was the single most important factor accounting for the overall contraction of financial flows to developing countries. From 1970 to 1981 there was a steep increase in bank lending by more than tenfold in current prices. The following seven years, however, witnessed a decline which was even steeper, and by 1988 net flows of bank loans to all developing countries (excluding offshore centres) had become negative. The dramatic turnaround in the role of bank lending in response to the debt crisis was the largest single source of negative net transfers. Since 1982, bank creditors received a net transfer from developing countries averaging $23 billion annually, the bulk of which ($15 billion) came from Latin America.

47. Under the Baker initiative, commercial banks were expected to increase their exposure to the HICs by $20 billion over 1986-1988. But they actually provided $13 billion in new money and when account is taken of repayments, the net flow was only $6 billion, or less than one third of the targeted amount, and highly concentrated in a few large debtor countries where the exposure of some major banks was uncomfortably large.

48. In 1988, net bank lending was negative not only for developing countries as a whole but also for most of the developing regions. This fall reflects most importantly the determination of banks to reduce their exposure to developing countries not only through reductions in the pace of lending but also through various market-related mechanisms such as debt-equity conversions. Banks' efforts to reduce their exposure have been directed primarily towards developing countries with debt-servicing difficulties. However, the recent behaviour of bank lending also reflects low levels of demand on the part of certain Asian countries, some of which have taken advantage of their strong external payments positions to make net repayments to banks. 9/

2. Foreign direct investment

49. Since the onset of the debt crisis, the prevailing policy view was that the role of foreign direct investment (FDI) in development finance should be expanded both to redress the imbalance between debt-creating and non-debt-creating flows and to substitute in part for the sharp decline in commercial bank lending. Encouraged by international financial institutions and bilateral donors, many developing countries have made great efforts to attract FDI flows through the liberalization of investment régimes, the introduction of new incentives and the setting up of schemes aimed at the conversion of debt into equity. Despite improved receptivity, however, the results have been disappointing. Although FDI flows (excluding those to offshore centres) have recovered in the last few years from the trough

registered in 1985, by 1988 their volume in real terms was about half the peak level of 1981. Moreover, the recovery was largely concentrated in the Asian countries with low external debt profile and in few Latin American countries under the impetus of major debt-equity swap programmes which were, however, suspended in 1989. The share of developing countries in rapidly growing world inflows of FDI fell sharply to about 20 per cent in the late 1980s.

50. Several factors were responsible for the collapse of FDI flows in the mid-1980s and their continuing depressed level; foremost among such factors is the debt crisis. In debt-distressed countries, severe external imbalances, depressed economic conditions, wide swings in real exchange rates and high inflation all contributed to a climate that was not conducive to FDI. Reduced profitability of existing foreign investments not only acted as a disincentive for further investment but also decreased the funds available for that purpose. Furthermore, in economic environments afflicted by foreign exchange stringency, investors encountered serious problems in importing raw materials and spare parts, and in making profit remittances.

51. At the global level, weak commodity prices during much of the 1980s and overcapacity in a number of important industrial subsectors such as textiles, steel and petrochemicals, contributed to the fall in FDI. Technological advances have also played a role. Recent innovations are largely labour-saving and have thus eroded developing countries' comparative advantage due to their low wages. The development of new materials and techniques aimed at reducing the consumption of energy and raw materials has also had adverse consequences on FDI in commodity-exporting developing countries. At the same time, foreign investors have made greater use of the new forms of investment, such as joint ventures, licensing agreements and subcontracting, which allow firms to earn attractive returns even in troubled countries, while minimizing equity participation, and thus exposure to the commercial and political risks that are associated to traditional FDI. In addition, although developing countries have participated in the expansion of FDI in services which now accounts for half of world FDI flows, a significant portion of this investment is concentrated in a handful of offshore financial centres and countries offering flags of convenience. Finally, foreign investment in developed market economies became increasingly attractive, with improved economic performance in OECD countries, financial deregulation, privatization, and increased business opportunities in the view of the unified EEC market after 1992.

52. One way of reducing external debt and at the same time expanding FDI is through the conversion of debt into equity. By the end of 1988, 17 countries, including all major debtors, had instituted debt-equity swap schemes, with a variety of features, usually within the context of broader debt conversion mechanisms. 10/ The annual value of these swaps rose rapidly from an average of $1.4 billion in 1984-1986 to $9.2 billion in 1988. 11/ However, for 1989 the volume of swaps was expected to fall sharply because of the suspension of such programmes in Argentina, Brazil and Mexico, which accounted for the bulk of the transactions. The suspension was explained by the adverse impact of the schemes on monetary expansion and concerns about "round-tripping" of capital.

53. The additionality of debt-equity swaps has been another cause for concern. It is extremely difficult to assess the extent to which these schemes have attracted FDI that otherwise would not have taken place. An empirical study undertaken by IFC 12/ concludes that virtually every

investment made by original creditors (i.e. the commercial banks) would not have happened without a swap programme. In the case of other investors, about one third of the investment was prompted by the swaps, while the size or the timing of another 10 per cent of these investments was influenced by the schemes. Interestingly, additionality was higher for export-oriented investments. In conclusion, although debt-equity swaps appear to have contributed to the recovery of FDI in some Latin American countries, their potential for reducing debt levels has been greatly overestimated and they can easily become a source of financial instability, given the size of external debt compared to the monetary base. 13/

54. On the international policy front, a major development has been the establishment of the Multilateral Investment Guarantee Agency (MIGA) in 1988 after a long gestation. MIGA's primary objective is to promote the flow of foreign investment to developing countries by issuing guarantees against non-commercial risks. As of June 1989, 52 countries were members of MIGA, of which 36 were capital-importing countries. In its first year of activity, MIGA had not yet started writing cover, although it had received applications for potential investments in 24 countries. MIGA's ability to stimulate new investment flows is largely predicated on an expansion in its membership (major host countries such as Argentina, Brazil, India, Mexico, and Venezuela have not yet joined) and its co-operation with private underwriters and national insurance schemes. Some of these schemes are larger than MIGA, which is endowed with an insurance capacity of only SDR 1 billion.

55. These broad recent trends tend to confirm that there is a weak correlation between a host country's receptivity to foreign investors and the actual flow of FDI. An expansion in FDI in debt-distressed countries would undoubtedly contribute to the alleviation of the debt crisis. But, as long as the debt overhang persists, it will continue to dampen FDI, as well as other private flows to these countries.

3. Export credits

56. Net flows of export credits contracted sharply during the 1980s. By 1987, total export credits - including those at short-term - were slightly negative. They recovered somewhat to a positive $1 billion in 1988, reflecting, however, an accumulation of arrears rather than an increase in new loans. All developing regions were affected by the precipitous decline in export credits, especially Latin America, North Africa and Middle East. Moreover, during 1986-1988 approximately half of developing countries experienced negative net flows of export credits. 14/

57. Recent movements in export credit financing have resulted from factors on both the demand and the supply sides, and from their interaction. For the majority of developing countries, the main influences have been reduced demand for certain categories of their own exports, higher interest rates than those typically prevalent in the second half of the 1970s and other factors associated with impaired creditworthiness and external financial stringency. Thus, for example, low levels of world demand for mineral commodities have led to reduced investment in new mining projects in developing countries, the financing of which is often a source of demand for export credits. External financial stringency and impaired creditworthiness have depressed export credits through the interaction of demand and supply. When a country's balance-of-payments position deteriorates, the increased risks associated with

financing and payments arrangements for its imports lead to the imposition by export credit agencies (ECAs) of higher costs and more restrictive conditions on their insurance cover for private export credits (thus accentuating the very external financial stringency which is the source of these increased risks). The effects on export credits of such actions on the supply side are added to reductions in demand resulting from deflationary measures taken in response to unfavourable changes in the balance of payments. During the 1980s, such measures have led to widespread reduction of gross investment in developing countries, and thus to lower imports of capital goods, which are the main sources of demand for medium-term and long-term export credits. It has also been argued that demand for export credits on the part of developing countries with unimpaired creditworthiness as well as those experiencing external financial stringency has contracted in response to the increased attractiveness of alternative financing and payments arrangements, as market rates of interest decreased in relation to the minimum rates under the OECD Consensus.

58. While the supply situation has improved somewhat with the introduction of new cover policies, 15/ which allowed some ECAs to re-enter selectively the rescheduling countries' market, the demand situation remains depressed. Continuing external payments difficulties make a return to large-scale project financing in most developing countries unlikely in the near term.

59. Weak demand conditions in developing countries and declining business opportunities have led to intensified competition among ECAs, resulting in an increased use of mixed credits, a combination of export credits and ODA. This practice tends to create trade and aid distortions by increasing the tied portion of ODA and favouring capital-intensive and import-intensive projects, particularly in upper-middle income countries. Aware of these problems, DAC countries adopted in 1987 a new set of "Guiding Principles for Associated Financing and Tied and Partially Untied ODA". This replaced the 1983 Guiding Principles, imposing greater transparency and stricter rules regarding the concessionality and the developmental standards of such transactions. None the less, the current situation is still regarded by DAC countries themselves as unsatisfactory. At present, these countries are considering a number of possible ways to strengthen the 1987 Guidelines, such as making some sectors and certain more advanced developing countries ineligible for mixed credits, obliging lenders to open up mixed-credit projects to international competitive bidding, limiting the share of aid budgets that can be applied to mixed credits, and devising rules to ensure that mixed credits only go to projects with genuine development value.

Chapter II

DEVELOPMENT FINANCE: SOME ISSUES FOR THE 1990s

60. The 1990s will pose a series of challenges in the area of development finance. Some of these involve the successful resolution of acute problems that have been at the centre of policy concern throughout most of the 1980s - for example, grappling with the consequence of excessive external indebtedness in many developing countries, a matter that is taken up in detail in "Debt and managing adjustment: attracting non-debt-creating financial flows and new lending" (TD/B/C.3/234). Others, for example strengthening the domestic savings effort and fostering an efficient mobilization and appropriate allocation of domestic savings, are long-standing concerns that have always been an integral part of the development process itself. These concerns, however, take on fresh relevance in the context of the 1990s, when the overall contribution of transfers from abroad to the financing of domestic investment can be expected to be negligible, or - as was the case for many countries through most of the 1980s - negative. Still other issues - for example dealing with the external financial dimensions of environmental concerns or the process of rapid political and economic reform in Eastern Europe - are of more recent vintage.

61. Addressing these challenges will require intensified policy effort across a wide front. In this effort, particular importance attaches to the need to encourage the contribution of private sources of capital to the funding of development. In this regard, continuous attention needs to be directed toward improving the functioning of national financial and capital markets. Attention also needs to be directed toward putting in place and maintaining an appropriate set of incentives for foreign direct investment.

62. A number of important issues relating to the external financing of development during the 1990s will be influenced primarily by the policies of creditor-country Governments. The paragraphs that follow take up briefly some of these issues.

A. The supply of external finance

63. The supply of external finance - both official and private - will be influenced by the macro-economic policies of industrial countries and by the co-ordination of such policies. The present pattern of capital flows is far from being adequate to promote a high, stable volume of development finance. The huge United States current account deficit represents a major drain on world savings, which are in short supply. Reduced savings propensity in OECD countries, particularly in the United States, has put upward pressure on real interest rates and has contributed to the fall in capital flows to the developing world. There is a growing recognition that higher savings rates in developed market economies could improve their capacity to provide an increased net flow of resources to developing countries. In that sense, the argument often made that high rates of domestic savings in some industrial countries with huge current account surpluses should be reduced seems questionable.

64. Furthermore, policy co-ordination among industrial countries has almost entirely focused on attempting to reconcile imbalances only among themselves. It has not included among its objectives the generation of a current account surplus within their group, and the design of appropriate mechanisms for

channelling targeted surpluses towards developing countries. Multilateral institutions can play a key role, by explicitly attempting to integrate development finance concerns and issues into the process of policy co-ordination.

65. Despite the absence of a multilateral framework, over the past few years, Japan has implemented important recycling programmes for developing countries. Since 1986 three such programmes have been launched amounting to a total of some $65 billion to be channelled to developing countries either bilaterally or through the MFIs for the period ending March 1992. This sum is intended to be largely additional to Japan's ongoing ODA programmes.

66. The Japanese recycling experience displays several interesting features, that should be taken into account in the design of appropriate mechanisms to channel capital flows to developing countries. First, much of the Japanese recycling takes the form of co-financing with the MFIs, including the recent $10 billion support to the Brady initiative. Second, loans from the Export-Import Bank of Japan are completely untied. This not only provides greater flexibility to developing countries for purchasing in international markets, but it is also a potentially powerful indirect way to reduce the trade deficit of Japan's major trading partner, the United States, without depressing the world economy. Third, Japanese recycling relies extensively on "hybrid" flows, that is joint financing arranged by the Government in collaboration with the private sector. In this scheme, the private institutions gather funds while public institutions serve as intermediaries to reduce the risk of channelling funds for investment projects in developing countries. Government resources are used mainly to provide some form of appropriate guarantee and - particularly in the case of low-income countries - to provide an interest subsidy.

67. Despite these efforts, however, by 1988 Japan was providing overall net flows to developing countries equivalent to only 0.75 per cent of its GNP, of which less than half was on concessional terms. This represented a decline over 1985, when the corresponding ratio was 0.87, as the recycling programme was not able to offset fully the retrenchment of Japanese banks from debt-distressed countries. By comparison, the Federal Republic of Germany, another surplus country, exported capital to the developing countries amounting to 0.98 per cent of GNP in 1988, up from 0.92 in 1985. It should be recalled, however, that over the next few years, Japan's recycling performance is expected to improve substantially in view of recent pledges.

B. The adequacy of official development finance

68. The outlook for the supply of official development finance is particularly bleak. Both concessional and non-concessional flows face unfavourable prospects, although for different reasons. According to the most recent projections made by the OECD secretariat, ODA flows from all donors are expected to expand at an average annual rate of only about 2 per cent over the next few years. The global outcome is heavily dependent on the projected rapid increase in Japan's ODA and by the evolution of the United States aid programme, which is expected to remain stable in nominal terms, at least in the near future. The DAC itself has recently expressed deep concern at the outlook for the United States aid budget. 16/

69. Prospects for multilateral concessional assistance are equally poor. The amount recently agreed upon for the ninth IDA replenishment implies no increase in real terms over the resources of IDA-8. But the worsened debt crisis, commodity price declines and the urgent need for further adjustment have considerably raised recipients' requirements. At the same time, stagnant IDA resources have to accommodate the needs of newly eligible major countries such as Nigeria, and possibly Angola. Under this scenario, it is difficult to envisage how the financial needs of sub-Saharan Africa will be met. The World Bank has recently estimated 17/ that for that region to grow at 5 per cent annually in the 1990s, ODA flows would have to expand at 4 per cent a year in real terms. The share of sub-Saharan Africa in IDA has already been raised to 50 per cent, and its share in global ODA has reached 30 per cent. In the absence of a further major increase in global ODA, a further shift of aid from other developing countries to Africa will hinder their adjustment efforts.

70. A forthcoming challenge for international financial co-operation is the replenishment of the concessional resources of the regional development banks in 1990. This is an opportunity to correct the inadequacy of IDA-9 resources. In addition, the SDR 6 billion funds allocated to ESAF are expected to be entirely committed by the end of 1990. SAF reflows could be used to replenish partially the ESAF. But they would become available several years after the expected exhaustion of ESAF resources. Therefore, the issue of the ESAF replenishment will arise shortly.

71. Assessing the future adequacy of non-concessional multilateral resources has become a difficult task, because of their increasing complementarity with private flows and debt reduction operations. The main issue here is the extent to what lending from MFIs to the HICs can safely increase without jeopardizing both the MFIs' ability to provide adequate financing to other borrowers and the creditworthiness of the MFIs themselves.

72. The Bretton Woods institutions will be playing an increasingly important role in the strengthened debt strategy for the HICs over the next three years. The IMF and the World Bank are expected to provide resources amounting to $20 billion to $25 billion to support debt and debt service reduction. Half of these amounts will be additional to currently planned lending programmes for the HICs. A further $10 billion will be made available by Japan. There are strong doubts, however, as to whether the size of the debt reduction attainable with these resources would be sufficient to remove the debt overhang, and thus increase adjustment incentives significantly. 18/ In the early 1990s, the expected reduction in annual debt service is estimated to average about $6 billion for the 19 HICs which are likely to benefit from the scheme. 19/ This will not be sufficient to cover the $10 billion annual financing gap arising from projected external financial requirements consistent with a modest growth in per capita income. The remaining $4 billion gap could be filled by new money from banks. But there are serious questions as to the extent to which it would be possible to combine the new money with significant debt reduction. In any case, further bank borrowing by the HICs would increase debt ratios and substantially offset the benefits of the debt reduction envisaged so far.

73. Under these circumstances, the MFIs are confronted with serious dilemmas. The World Bank, for example, might consider increasing its lending to the HICs, either by providing more money for debt reduction or by expanding the volume of its normal operations. Both alternatives, however, raise several issues:

(a) Depending on the magnitude of the increase in lending to the HICs, possible diversion of resources from other needy borrowers, including Eastern European countries, unless the capital base, which sets overall lending limits, is correspondingly enhanced;

(b) Increased net indebtedness by the HICs, if further lending is not channelled to debt reduction;

(c) Increased exposure of the MFIs in the HICs. This exposure might approach prudential limits. With the implementation of the Brady initiative, the share of debt service due to the MFIs in total debt service by the HICs is already expected to rise to 30 per cent. A larger share may affect the preferred creditor status of the MFIs. In addition, there could be a large new stock of debt resulting from debt reduction operations which involve the conversion of old debt into new debt whose service is partially guaranteed by the MFIs. Such debt service is estimated to account for an additional 15-25 per cent of total debt service, thus further restraining the flexibility in the HICs' debt structure; and,

(d) Uneven burden sharing between the official sector and the commercial banks. To be sure, it may be argued that massive bank lending in the 1970s was a historical aberration, and what is currently taking place is not only a transfer of risks from the private to the official sector but, more important, a transfer of tasks. The capital markets' reluctance to lend to the HICs may be also viewed as a temporary market failure, which strengthens the case for a greater role for official flows until creditworthiness is restored. The multilateral institutions have a special commitment to assist developing countries in restoring growth and financial viability, a commitment that private lenders do not have. The issue here is how to strike the right balance between the increased exposure of the official creditors and the losses incurred by private creditors. Such a balance should contribute to both a major improvement in the HICs' creditworthiness and the preservation of the MFIs' credit-standing.

74. To conclude, a significant increase in multilateral lending to the HICs cannot be envisaged unless it takes place in the context of a considerable additional reduction in commercial bank debt, which should be effected through means other than the resources of the multilateral institutions. As a former senior official of the IMF points out: "the institutions' major members may prefer to risk 'the Fund's money' or 'the Bank's money' (which is their own money only in event of liquidation of the institution) rather than facing the alternatives: providing fresh money of their own or contemplating the financial and political implications of default". 20/

75. A related issue is how the IMF can play a significant role in reducing - rather than increasing - negative net transfers in developing countries generally. Traditionally, Fund financing has not been considered as a component of development finance. In the 1980s, however, with the Fund's involvement in the debt crisis and its lending virtually confined to developing countries, it has become inextricably linked to the policy issues pertaining

to development finance. The developing countries drew heavily from the Fund during the 1980s. As of September 1989, outstanding drawings amounted to around SDR 25 billion, a sum to be repaid over the medium term, unless the "continued use" provisions are changed. Otherwise, not only net transfers but also net disbursements from the Fund to developing countries will continue to be negative. In view of the increased financial needs of developing countries and Eastern European countries, the increase in IMF quotas which is likely to emerge from current negotiations will fall far short of requirements.

76. The 1980s witnessed an increased interaction between the Bank and the Fund. The time is ripe to review thoroughly the respective roles of the two institutions, to what extent overlapping is necessary, and to what extent their co-operation is appropriate to enhance their effectiveness, while minimizing undue pressures on borrowing countries. More generally, questions have been recently raised about the flexibility of multilateral institutions and flows in meeting the specific needs of developing countries. Such questions cover the ability of these institutions to support policy reform efforts, the right balance between short-term and long-term lending, and between balance-of-payments support and project assistance. All these concerns deserve full scrutiny.

C. Environment

77. The rationale for external support of natural environmental conservation in developing countries is based on the concept that the environment is a global concern of all developed and developing countries because of externalities involved. Environmental conservation in developing countries will undoubtedly help to improve the global ecological system and have an environmental value for developed countries. In a way, the preservation of green land and tropical forests will contribute to neutralizing to some extent the excess production of carbon dioxide, which results from the burning of large quantities of fossil fuels, above all in the affluent industrial countries. Furthermore, wildland management is the least costly and, in many cases, the only means available for maintaining biological diversity. Environmental goods are underpriced and even considered as free goods, which has led to over-exploitation. Putting the right price to environmental services implies that financial flows related to global environmental protection are indeed payments made by developed countries for the services rendered to them by the natural resources of developing countries. These flows should not be viewed as development assistance.

78. Debt-for-nature swaps, although still limited, have to some extent contributed to provision of additional resources for the conservation of nature in debtor developing countries. These swaps are attracting considerable public sympathy in developed countries and are a dawning recognition of the value of natural areas to the world economy. 21/

79. Where environment problems are of global reach but largely the outcome of economic activities in developed countries - the depletion of the ozone layer and the threat of global warming are cases in point - elementary fairness would urge the countries responsible to shoulder the costs of prevention and, in case of environmental damage, to negotiate with the countries which have suffered the damage.

80. It is also sensible to help weaker economic agents in the transition to less polluting processes, since this is likely to reduce pollution more quickly. Where the global environment is concerned, it is in the interest of the countries which hold a technological lead to encourage the rapid and widespread adoption of environmentally-benign technologies.

81. In developing countries, environmental degradation is closely linked with the persistence of poverty and restricted economic opportunities for the poorest. Deforestation, desertification and degradation of cultivated land are often the result of over-exploitation of natural resources by the poor to earn their living. This process is unsustainable and if no action is taken, environmental deterioration will deprive future generations of a sound resource base. The solution should be found in broad-based development programmes integrating the poor in the development process. These programmes should include actions in such areas as human resource development as well as projects aimed at restraining land degradation, deforestation and desertification, overcoming the shortage of fresh water resources and reducing water pollution. Environmental problems in developing countries can only be solved in the context of national objectives for growth and development, taking into account the interests of the poor and avoiding externally imposed criteria and conditionality.

D. The impact of reforms in Eastern Europe

82. Far-reaching economic changes are taking place in Eastern Europe. The countries differ considerably among each other in the direction and nature of the reforms as well as in their production structures. Nevertheless, all share the determination to increase their participation in international trade and finance, and most are seeking to assign a much larger role to market mechanisms.

83. Many uncertainties still prevail regarding the content and the pace of the reform process. How these reforms will affect the volume and pattern of financial flows to developing countries is also unclear. The following preliminary observations can, however, be advanced.

84. Economic and social restructuring in Eastern European countries and their progressive integration into the world economy will require new inflows of financial resources in convertible currencies on an unprecedented scale. The size and timing of the financial needs will naturally depend on the scope, sequencing and tempo of the reforms, as well as on domestic efforts aimed at maintaining high savings propensity in the face of strong pressures to increase consumption.

85. The issue that arises in the context of development finance is with regard to the magnitude of the response from developed market-economy countries and the impact which this support might have on these Governments' willingness to maintain or increase financial assistance to developing countries. OECD Governments have already formulated an initial response to the financial requirements of reforming countries. By January 1990, the OECD countries had pledged more than $9 billion in financial commitments to support economic reforms in Poland and Hungary. These commitments included grants, loans, technical assistance, debt forgiveness, export credits, and other forms of assistance such as food aid. Developed market-economy countries also announced their readiness to widen the scope of financial

assistance to Eastern Europe by extending it to Bulgaria, Czechoslovakia, the German Democratic Republic and Yugoslavia "at the time they put into place the necessary political and economic reforms".

86. External financial support to Eastern European countries could be provided through four broad channels: bilateral concessional assistance, multilateral loans, official or officially guaranteed export credits, and spontaneous flows from the private sector.

87. Considerable discussion - in both developed and developing countries - has focused on the extent to which concessional bilateral assistance to reforming countries might divert resources from traditional aid recipients, which already face stagnant ODA and much reduced private flows. Concern over this issue has led to reassurances by DAC Aid Ministers that the support to Eastern Europe "will not diminish their determination to give high priority to their development co-operation with the Third World". 22/ At the same time, "some Ministers foresee the possibility of also having recourse, within such assistance programmes, to official development aid funds while safeguarding flows to traditional recipients of official development aid". 23/ Nevertheless, it is widely recognized that, at least in the short run, there is a risk of diversion of funds from development aid budgets, especially in donor countries where the budgetary situation is particularly tight. In other cases, it might be avoided with considerable policy effort. It should be emphasized, however, that concessional assistance in the form of grants and soft loans is viewed by donors as needed support for emergency situations and to help the transition, as in the case of food aid and the financing of a currency stabilization fund for Poland. Once the critical initial phase of reforms is completed, one would expect that most external flows going to Eastern Europe would be non-concessional, as in the case of developing countries at similar income levels. Furthermore, there is speculation that in the longer-run the "peace dividend" - that is the reduction in arms expenditures resulting from the relaxation of East-West tensions - would ensure additionality in aid programmes. It is also expected that bilateral aid from OECD countries will be increasingly in the form of technical assistance rather than financial support.

88. With regard to multilateral flows to Eastern Europe, it should be noted that those countries that are members of the Bretton Woods institutions - Hungary, Poland and Romania - have access to their facilities as a source of financing. Czechoslovakia has recently applied to rejoin these institutions. The question of possible membership for the remaining countries has already arisen. If a massive lending programme for Eastern Europe were to materialize, the issue that arises is whether it could be accommodated within the existing lending limits of multilateral institutions without "crowding out" planned financial assistance to developing country members. In the near term, multilateral institutions, such as the World Bank, have some leeway to expand total lending with existing resources and therefore ensure additionality. Over the longer term, however, the need for a general capital increase might arise in order to meet the much expanded financial requirements of a larger membership. Under that scenario, however, most of the OECD contributions to the capital increase of the Bank will be in the form of callable capital, that is guarantees, rather than cash. These guarantees will allow the Bank to increase its borrowing from international capital markets where, in contrast to foreign aid, supply constraints are much less important.

89. The same considerations may apply to the proposed European Bank for Reconstruction and Development, which is expected to have a wide membership and an authorized capital of some $12 billion, and would undertake operations in an amount of about $2 billion annually. These operations would include loans - at market-related interest rates or through a concessional window - guarantees, equity investment, joint ventures and technical assistance. Since the financial structure of the proposed institution is modelled on the regional development banks, guarantee capital would constitute the bulk of its capital stock, reportedly 80 per cent. Its concessional window, however, may compete for scarce aid allocations.

90. As regards official or officially guaranteed export credits, the key question is the extent to which the resources of the ECAs will be used to expand bilateral flows to the region. This will depend in part on the speed of the expected expansion in East-West trade, which is in turn predicated on the opening of markets to exports of Eastern European countries. However, a factor limiting the growth of export credits, especially in the debt-distressed countries of the region, will be the normal prudential guidelines governing the risk exposure of these institutions. Furthermore, the relative importance of short-term credits versus long-term operations would have a bearing on the funding of the ECAs, and thus on their ability to lend to developing countries. And again, ECAs's possible needs for further resources would have different repercussions on financial flows to developing countries, depending on the extent to which the ECAs' resources derive from financial markets or from budgetary allocations.

91. In the past, there have occurred considerable financial flows from private banks in industrial countries to the Governments of Eastern Europe. The overall economic crisis gripping these countries led a number of them to seek the rescheduling of bank loans. Although prospects would vary from country to country, it must be presumed that on the whole commercial banks would try to limit their exposure in highly indebted countries. But loans to countries without debt servicing difficulties may rapidly increase. These loans would be provided by the huge market for credits to creditworthy developing and developed countries, a market where supply-side considerations play a reduced role.

92. As regards foreign direct investment, including joint ventures, the attractiveness of the East European countries will depend importantly on the pace of the process of reform itself, the maintenance of a stable investment climate, as well as the specific provisions governing the operation of the foreign ventures. Thus, although Eastern European countries will be a more attractive outlet for private investment in the future than they had been in the past, it is unclear as to whether the magnitudes of such flows would be significant on an international scale. Foreign direct investment in developing countries - or elsewhere - is not, to a major extent, supply-constrained, as transnational corporations have easy access to international capital markets to fund their operations. However, the availability in Eastern Europe of a skilled and educated work force at attractive wage rates could influence the decisions of such corporations on the location of new investment.

93. To conclude, the recent and expected response of the OECD countries to the reform efforts of Eastern Europe may carry a risk of diversion of flows from developing countries, especially as regards ODA. As for the other flows, the risk is much lower overall, but may be significant in particular instances. Every effort should be made to ensure true additionality, in both the short and the medium term. Cuts in defence expenditures would be of great help in this regard. Over the longer term, effective transition to sustained growth in reforming countries would also benefit the whole international community. Developing countries would gain from increased exports to these markets as well as from increased financial assistance from Eastern European Governments.

Notes

1/ Throughout the report, "real terms" means at 1987 prices and exchange rates.

2/ These initiatives are examined in "Debt and managing adjustment: attracting non-debt-creating financial flows and new lending" (TD/B/C.3/234), chap. I.

3/ See OECD, Development Co-operation, 1987 Report, p. 66.

4/ Study prepared by D.R. Panday and M. Williams, to be issued.

5/ World Bank, Sub-Saharan Africa: From Crisis to Sustainable Growth (Washington, D.C., 1989), p. 14.

6/ OECD Press Release, 5 December 1989.

7/ These measures are described in TD/B/C.3/234, paras. 15-19.

8/ TD/B/L.864.

9/ Broader issues regarding bank lending and policies under the Brady plan are examined in TD/B/C.3/234, chap. I, sect. B.

10/ For details of these schemes, see Trade and Development Report, 1988, pp. 106-107 and Trade and Development Report, 1989, p. 106.

11/ See World Bank, World Debt Tables, 1989-90, (Washington, D.C., 1989), p. 18.

12/ J. Bergsman and W. Edisis, Debt-Equity Swaps and Foreign Direct Investment in Latin America, IFC Discussion Paper No. 2, Washington, D.C., 1988.

13/ See TD/B/C.3/234, paras. 82-85.

14/ See Trade and Development Report, 1989, p. 36.

15/ See ibid., pp. 52-55.

16/ "In the view of the Committee the shrinkage of [U.S.] resources available for aid had serious implications for equitable burden sharing among donors and for the ability of the United States to participate effectively in common efforts in areas of critical development concerns" OECD Press Release, 11 December 1989.

17/ World Bank, Sub-Saharan Africa ... op. cit., p. 179.

18/ See TD/B/C.3/234, chap. I, sect. B.

19/ See World Bank, World Debt Tables ... op. cit., p. 25

20/ J.J. Polak, Financial Policies and Development, OECD, 1989, p. 179.

21/ For a detailed analysis of these swaps, see Trade and Development Report, 1989, Box 6, pp. 44-45.

22/ OECD Press Release, 5 December 1989.

23/ See Declaration of Ministers of the "Group of 24 for Economic Assistance to Poland and Hungary", 13 December 1989.

TABLE 1

NET FINANCIAL FLOWS TO DEVELOPING COUNTRIES, 1980-1988
(billions of dollars, at current prices)

	1980	1981	1982	1983	1984	1985	1986	1987	1988 [a]	Percentage of total	
										1980	1988
Official flows	44.5	44.7	43.2	40.7	46.3	46.9	54.2	60.8	65.7	35.7	65.6
Official development assistance	36.8	36.0	33.1	32.5	33.6	35.3	42.2	47.1	49.6	29.5	49.5
Bilateral	29.0	28.1	25.5	24.9	25.8	26.8	32.7	37.0	38.6	23.3	38.5
Multilateral	7.8	7.9	7.6	7.6	7.8	8.5	9.5	10.1	11.0	6.2	11.0
Non-concessional official flows	7.7	8.7	10.1	8.2	12.7	11.6	12.0	13.7	16.1	6.2	16.1
Bilateral	3.1	3.1	3.6	1.1	4.6	3.9	4.2	6.7	8.1	2.5	8.1
Multilateral	4.6	5.6	6.5	7.1	8.1	7.7	7.8	7.0	8.0	3.7	8.0
Total export credits	16.5	17.1	13.3	4.3	6.1	4.4	0.2	-0.2	0.9	13.2	0.9
Private flows	61.3	69.4	51.9	43.7	27.0	25.3	28.5	32.5	30.0	49.2	29.9
Direct investment	11.1	17.0	12.5	9.4	11.1	6.2	11.1	19.7	18.5	8.9	18.4
of which: Offshore centres	3.0	4.1	4.1	3.7	3.8	3.7	6.8	12.0	..	2.4	..
International bank lending	47.8	49.6	34.8	33.6	16.0	12.4	9.0	7.5	6.3	38.4	6.3
of which: Short-term	26.0	22.0	15.0	-25.0	-6.0	12.0	-4.0	5.0	..	20.8	..
Total bond lending	0.4	1.0	4.0	0.1	-1.2	3.8	3.1	-0.2	1.2	0.3	1.2
Other private	2.0	1.8	0.6	0.6	1.1	2.9	5.3	5.5	4.0	1.6	4.0
Grants by non-governmental organisations	2.4	2.0	2.3	2.3	2.6	2.9	3.3	3.3	3.6	1.9	3.6
Total net resource flows	***124.7***	***133.2***	***110.7***	***91.0***	***82.0***	***79.5***	***86.2***	***96.4***	***100.2***	***100.0***	***100.0***
Memo item: Net financial transfers [b]	37.7	39.8	9.1	-0.8	-11.8	-20.9	-17.3	-28.5	-35.6		

Source: UNCTAD secretariat estimates, based on data from OECD, Development Co-operation, various issues; OECD, Geographical Distribution of Financial Flows to Developing Countries, various issues; International Monetary Fund, Balance of Payments Statistics.

a Estimates.

b Based on balance of payments statistics for a sample of 107 developing countries, excluding capital-surplus countries (Brunei Darussalam, Iran (Islamic Republic of), Iraq, Kuwait, Libyan Arab Jamahiriya, Qatar, Saudi Arabia, United Arab Emirates).
Net financial transfer is defined as the net flow of all forms of capital (including IMF flows), minus net capital servicing (interest payments and profit remittances), but excluding changes in official reserve assets.

TABLE 2

NET FINANCIAL FLOWS TO DEVELOPING COUNTRIES IN REAL TERMS, 1980-1988
(billions of dollars at 1987 prices and exchange rates)

	1980	1981	1982	1983	1984	1985	1986	1987	1988 [a]	Real average annual growth rate	
										1971-1980	1981-1988
Official flows	58.8	61.3	60.7	57.4	66.7	66.8	62.3	60.8	61.3	6.3	0.0
Official development assistance	48.6	49.4	46.5	45.8	48.4	50.3	48.5	47.1	46.3	5.3	-0.9
Bilateral	38.3	38.6	35.8	35.1	37.2	38.2	37.6	37.0	36.0	4.3	-1.0
Multilateral	10.3	10.8	10.7	10.7	11.2	12.1	10.9	10.1	10.3	9.9	-0.7
Non-concessional official flows	10.2	11.9	14.2	11.6	18.3	16.5	13.8	13.7	15.0	13.4	3.4
Bilateral	4.1	4.2	5.1	1.6	6.6	5.5	4.8	6.7	7.6	26.3	8.8
Multilateral	6.1	7.7	9.1	10.0	11.7	11.0	9.0	7.0	7.4	9.0	-0.6
Total export credits	21.8	23.5	18.7	6.1	8.8	6.3	0.2	-0.2	0.8	9.2	-38.3
Private flows	80.9	95.2	73.0	61.6	39.0	36.1	32.9	32.5	28.0	15.2	-16.0
Direct investment	14.7	23.3	17.6	13.2	16.0	8.8	12.8	19.7	17.3	3.7	-4.2
of which: Offshore centres	4.0	5.6	5.8	5.2	5.5	5.3	7.8	12.0	..	..	..
International bank lending	63.1	68.0	48.9	47.4	23.1	17.7	10.4	7.5	5.9	22.4	-29.4
of which: Short-term	34.3	30.2	21.1	-35.2	-8.6	17.1	-4.6	5.0	..	..	..
Total bond lending	0.5	1.4	5.6	0.1	-1.7	5.5	3.6	-0.2	1.1	-7.4	-3.4
Other private	2.6	2.5	0.9	0.9	1.6	4.1	6.1	5.5	3.7	12.5	5.8
Grants by non-governmental organisations	3.2	2.7	3.2	3.2	3.7	4.1	3.8	3.3	3.4	0.4	3.3
Total net resource flows	***164.7***	***182.7***	***155.6***	***128.3***	***118.2***	***113.3***	***99.2***	***96.4***	***93.5***	***10.0***	***-9.1***

Source: UNCTAD secretariat estimates, based on data from OECD, Development Co-operation, various issues; OECD, Geographical Distribution of Financial Flows to Developing Countries, various issues.

a Estimates.

UNITED
NATIONS

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United Nations Conference
on Trade and Development

Distr.
GENERAL

TD/B/C.3/236
1 March 1990

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Committee on Invisibles and Financing
related to Trade
Thirteenth session (second part)
Geneva, 30 April 1990
Agenda item 6

REVIEW OF THE WORK PROGRAMME OF THE COMMITTEE

Review of the work programme of the Committee with respect to financing related to trade

Note by the UNCTAD secretariat

1. The present note has been prepared pursuant to paragraph 16 of Trade and Development Board resolution 231 (XXII) on rationalization of the permanent machinery of UNCTAD, which requested the main Committees to review regularly the elaboration of their work programmes and the implementation of their decisions, and in conformity with the measures contained in the report of the Ad hoc Intergovernmental Working Group on the In-depth Study of the United Nations Intergovernmental Structure and Functions in the Economic and Social Fields established pursuant to decision 347 (XXXIV) of the Trade and Development Board (TD/B/1154). The Ad hoc Working Group recommended that "each main Committee should, without prejudice to its mandate: (a) review the elaboration of its work programme and the implementation of its decisions; (b) consider and decide on the work ahead including tasks to be introduced or prolonged in the work programme; and (c) ensure that any specific tasks be clearly defined with a timetable for their accomplishment" (TD/B/1154, para. 7). More specifically, it also proposed that "the Committee on Invisibles and Financing related to Trade, at its next session, should give particular attention to the elaboration of a work programme, if possible for the four subsequent years" (ibid., para. 39).

I. FUNCTIONS AND WORK PROGRAMME OF THE COMMITTEE */

2. The Committee on Invisibles and Financing related to Trade is one of the three Committees that the General Assembly, in its resolution 1995 (XIX) of 30 December 1964, specifically decided should be established by the Trade and Development Board. The Conference itself, at its first session, in 1964, adopted a series of recommendations in such areas as the international monetary system, compensatory financing of shortfalls in export receipts of developing countries, supplementary assistance to help these countries avoid disruption of development programmes, growth and aid, debt service and debt rescheduling and mobilization of resources for development. The terms of reference of the Committee (resolution 10 (I) of the Trade and Development Board) include, inter alia, consideration of: the adequacy of rates of growth achieved by the developing countries, and in this connection to keep under review the mobilization of domestic resources by developing countries and their import capacity resulting from the combined total of export proceeds, invisible earnings and the capital inflow available to them, taking into account, inter alia, the evolution of prices; studies and proposals for increasing the net flow of financial resources to developing countries; means for (a) facilitating the co-ordination of and increasing the effectiveness of bilateral and multilateral programmes of development assistance to developing countries, taking into account efforts by the developing countries to mobilize effectively their domestic resources, and (b) improving the terms of such assistance, having in mind the differing economic situations and stages of development of developing countries; and keeping under review the problems of servicing of the external debts of the developing countries, keeping in view (a) the external capital requirements of developing countries, and (b) the increasing burden of those debts.

3. Since its first session, the Committee has considered a very broad range of issues. International monetary issues, international financial flows and mobilization of domestic resources have provided the broad framework within which particular issues have been identified and examined by the Committee. Prominent among these issues are international monetary reform; link between SDRs and additional development assistance; IMF's compensatory financing facility; a proposal for a supplementary financing facility; refinement of the concept of official development assistance (ODA) as regards both terms and conditions; adequacy of ODA flows and adherence to volume and terms targets; the role of private capital, including foreign private direct investment in the development process; use of export credits; access to capital markets and the particular characteristics of Euro-currency lending; examination of proposals for an export credit financing or guarantee facility; debt problems of developing countries; and measurement of development effort by developing countries. Some issues, such as aid performance and international monetary issues, have figured prominently at almost every session, while others have been the subject of intense activity at certain periods.

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*/ The activities of the secretariat, including, inter alia, support to the Committee's work programme, are set out in the Medium-Term Plans and Programme Budgets, the most recent of which are the draft UNCTAD sections of the Medium-Term Plan for the period 1992-1997 and the Programme Budget 1990-1991.

4. The Committees's work has been guided by requests addressed to it by the Conference and the Board, as well as by the General Assembly. The consultations of the Secretary-General of UNCTAD with representatives of regional groups on the provisional agendas of sessions of the main Committees, held pursuant to Board decision 143 (XVI), have also served to clarify issues on which the members of UNCTAD have wished to devote particular attention at one session or another.

II. INTERGOVERNMENTAL DECISIONS AND THEIR IMPLEMENTATION

5. At the first part of its twelfth session, in December 1986, the Committee reviewed international monetary issues and financial questions related to trade. It discussed the external financial difficulties of developing countries in the overall context of the poor performance of the world economy. Issues such as reverse net transfer of resources, contractions in flows to developing countries of bank lending, export credits and foreign investment together with their negative impact on the adjustment efforts of developing countries, in particular the least developed among them, were considered. The Committee examined the questions of stagnating official development assistance flows and the provision of aid in the form of mixed credits. It considered the notion of policy dialogue related to basic development strategies and highlighted the matter of the growing conditionality attached to ODA flows. It also discussed current problems in the field of trade financing, including the issues of external financial stringency, export credits and counter-trade. The deteriorating global economic environment, the growing financial disorder and the extent and nature of, and responses to, the debt problems of developing countries were also addressed.

6. The Committee, as a subsidiary body of the Conference and the Board, naturally responds to the requests and priorities of the higher instances of the organization. Its role as a technical body can serve to refine issues at the substantive level in support of their more political consideration in the higher bodies. The Committee, as the technically competent body of UNCTAD in the area of money and finance, also contributes to the responses made by UNCTAD to requests emanating from the General Assembly.

III. FUTURE WORK

7. Regarding the future work programme of the Committee, it was generally agreed at the first part of the twelfth session that, in view of the then forthcoming seventh session of the Conference, the Committee would not examine at length its work programme. Regional groups did, however, put forward some broad indications or guiding principles. All groups agreed that there should be a good balance between the consideration of broad issues falling within the Committee's mandate and more specific topics which would deserve the attention of the States members of UNCTAD: the Group of 77 suggested the inclusion in the future work programme of the Committee of items on external debt, ODA and the negative transfer of resources from developing to developed countries. Group B countries supported the idea that the Committee should address specific developments in the extremely complex international financial systems. Group D countries supported the Group of 77's proposals and insisted that the Committee should develop principles for the progressive reform of the international monetary and financial system. The countries of Group D also

emphasized the need to identify additional means of accelerating the development of the developing countries, including utilization of resources released by disarmament agreements and more effective co-operation among all countries.

8. The Final Act of UNCTAD VII addressed many issues of concern to the Committee such as the debt problem, external financial resources and the mobilization of domestic and human resources as well as related monetary questions. These issues were developed further in General Assembly and Trade and Development Board resolutions such as: General Assembly resolutions 41/202, 42/198, 43/198 and 44/205 on external debt, 43/197 on the fulfilment of the target for official development assistance as well as Board resolution 358 (XXXV) on the implementation of the guidelines of Board resolution 222 (XXI), and more recently its resolutions 375 (XXXVI) on debt and development problems of developing countries and 374 (XXXVI) on the interdependence of problems of trade, development finance and the international monetary system.

9. The draft UNCTAD sections of the United Nations Medium-term Plan for 1992-1997, as considered by the Working Party on the Medium-term Plan and the Programme Budget at its eighteenth session, as well as the 1990-1991 Programme Budget serve as further guidance to the Committee as to current issues of concern. The New International Development Strategy for the 1990s, the Second United Nations Conference on the Least Developed Countries and the forthcoming eighth session of the Conference in 1991 can also be expected to offer new ideas for the future work of the Committee.

10. The agenda of the present (thirteenth) session of the Committee includes a review of international monetary and financial questions related to trade and development, including, in particular, official development co-operation, (item 3), and a special item on debt and managing adjustment (item 4). The thirteenth session of the Committee will be the only session of the Committee taking place between the seventh and the eighth sessions of the Conference. Its work thus includes not only immediate substantive work and the future work programme but also the contribution it may make towards the identification and refinement of policy questions which will influence the shaping of the Conference agenda.

11. While the Committee may wish to keep its future agenda sufficiently flexible and open in order to respond to new developments (in particular with respect to its role in responding to or refining issues deriving from the higher instances of UNCTAD and, more broadly, the United Nations) it may also wish to identify certain special topics which might be explored in detail over the period of several Committee sessions. Such an approach would allow the Committee time to examine in greater depth some financial issues related to development economics. Thus the Committee may wish to maintain a broad general item on its agenda embracing its full mandate but with varying emphases reflecting current concerns. And, in addition, the Committee might wish to choose one or two special topics for in-depth consideration such as:

- Official development finance: aid volume and effectiveness; the role of multilateral financial institutions in the 1990s; the recycling of current-account surpluses to developing countries;

- Debt problems of developing countries: debt reduction; non-debt creating flows, their role in development finance, how they can be stimulated by official incentives and flows;

- Adjustment: interrelationships between the external environment and the scope for adjustment; the nature and scope of adjustment efforts by developing countries; fiscal policies; the impact of adjustment policies on social welfare, in particular protecting the poorest sectors of the population;

- Domestic resource mobilization: the role of the public sector in development; the requirements for full and effective utilization of private resources;

- International monetary issues: the exchange rate system and surveillance; international liquidity;

- Establishing a link between savings from disarmament and financing development.

12. It is the intention of the secretariat to have informal discussions with regional groups and China, prior to the session of the Committee, with a view to clarifying areas of primary interest. It is hoped that these discussions will assist the Committee in its selection of a small sub-set of topics for future in-depth examination.